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MANAGEMENT AND STRUCTURAL REFORMS AT THE SECURITIES AND EXCHANGE COMMISSION: A PROGRESS REPORT

HEARING

BEFORE THE

SUBCOMMITTEE ON
SECURITIES, INSURANCE, AND INVESTMENT

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

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ON

A PROGRESS REPORT ON THE MANAGEMENT AND STRUCTURAL REFORMS AT THE SEC

NOVEMBER 16, 2011

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C O N T E N T S

WEDNESDAY, NOVEMBER 16, 2011

WITNESSES

MANAGEMENT AND STRUCTURAL REFORMS AT THE SECURITIES AND EXCHANGE COMMISSION: A PROGRESS REPORT

WEDNESDAY, NOVEMBER 16, 2011

U.S. SENATE,
Subcommittee on Securities, Insurance, and Investment,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 9:31 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Jack Reed, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN JACK REED

Chairman REED. Let me call the hearing to order. I want to thank my Ranking Member, Senator Crapo, for joining us today, and I certainly want to thank the witnesses for taking time out of their very hectic and demanding and important schedules to be with us this morning. Our hearing is entitled, "Management and Structural Reforms at the SEC: A Progress Report." This is a very critical hearing because we understand the important role that the SEC plays in the regulations of our securities markets.

We have had vocal concerns about regulation, overregulation, but it appears indeed that revenues in the securities industries for each of the last 2 years have been greater than in any year in the previous 10 years. So the industry is, in fact, growing at a time when many other sectors of the American economy are in very serious distress. And I believe that those who want to starve the market watchdogs or repeal legislation seek a return to the days when toxic financial products were secretly negotiated and traded, profiting Wall Street bankers, and leaving taxpayers on the hook to clean up the mess later.

Congress acted to stabilize the market with the Dodd-Frank Wall Street Reform and Consumer Protection Act to bring transparency and certainty into the marketplace. There is no question that slowing down the regulations and those who enforce the regulations will benefit those on Wall Street so that they can make more money but at a hefty price to the rest of us. I think that is the lesson of 2008 and 2009 and continuing.

The Securities and Exchange Commission has a daunting job. It is charged with protecting investors and ensuring that our securities markets are operating in a fair and orderly manner. This is no small task given the growing volume and complexity of both markets and products.

For example, as of the end of October, the total market value of the United States equity market was estimated at $13.1 trillion. Approximately 45 percent of all U.S. households, or 92 million investors, make investments in the market, principally through mutual funds. So this is of interest to every American, not just those who are in the financial markets.

There is little doubt that changes in both technology and trading practices are affecting exchanges. Trading venues are increasingly fragmented with no single exchange holding more than one-fifth of the market share. More trading is being done off exchanges in so-called dark pools or by broker-dealers executing trades internally. Over the past year and a half, this type of trading has increased by more than 30 percent, presenting new and challenging problems to regulators.

Finally, high-frequency traders are using computers to execute trades in less than a blink of an eye. Although such trades may contribute to market volume in good times, they also may contribute to shrinking liquidity in times of market stress.

While the securities markets have exploded with novel products and increasingly faster technologies, many argue that the SEC has been left behind. The financial crisis revealed troubling failures, weaknesses, and gaps in regulation. The SEC had responsibility for the oversight of investment banks. The financial revealed that the SEC failed to appreciate the growing risks, failed to ask the right questions, and failed to take the right steps. This is the same pattern we saw in the Madoff Ponzi scheme case. The agency failed to stop Bernard Madoff's long-running investment fraud despite repeated warnings. It failed to ask the right questions and failed to take the right steps.

In addition, the agency's Inspector General has identified serious missteps in how the agency has handled information, how it conducts its operation, and how it executes its mission. Others have criticized the agency for inhibiting capital formation, decreasing U.S. competitiveness, and taking a light touch against law breakers.

But my sense is that the SEC appears to be committed to reform. Chairman Mary Schapiro has installed new leadership across the SEC's Divisions and Offices. Beginning in 2009, the SEC began restructuring its largest operating units: the Division of Enforcement and Office of Compliance Inspections and Examinations. The Commission has also created the Division of Risk, Strategy, and Financial Innovation to more closely examine new products, trading practices, and risk.

Congress has tried to focus on improving the SEC as well. In the Dodd-Frank Wall Street Reform and Consumer Protection Act, it was mandated that the SEC engage an independent consultant to examine its internal operations structure and need for reform. This report identifies several opportunities for reform, including reprioritizing regulatory activities, reshaping the agency to maximize efficiency and effectiveness, investing to improve infrastructure, and improving engagement with self-regulatory organizations.

The report also notes the considerable additional responsibilities placed on the SEC after the financial crisis and a gap in funding that cannot be overcome by improving efficiency. Congress must fully fund the SEC, our market watchdog, if it is to effectively discharge the mandate to police the markets and protect investors.

The SEC has been criticized for failures of its missions in the past. Today's hearing will focus on how the SEC's management has responded to this criticism and the need for reform. The securities markets need to work so that investors and companies can come together and allocate capital efficiently and productively, allowing new products, new technologies, and new jobs to be created. And they need to work for Americans who save for college, a new home, or retirement.

What is being done and what needs to be done to right-size this agency, to improve its ability to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation, and to reinvigorate its staff is at the forefront of our hearing today.

Our witnesses this morning are the senior-most management of all the SEC Divisions and the largest SEC program office. It is critical that Congress understand what is being done to move this agency forward and ensure that the missteps of the past are not repeated.

With that, I would now like to recognize my Ranking Member for his opening comments. Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Senator Reed, and I agree with and appreciate a number of your comments and concerns in your opening statement, and I also appreciate you holding this hearing. I am one of those, as you know, who thinks that we are having a little bit of difficulty getting it right in terms of our regulatory approach right now, and I appreciate these opportunities for oversight hearings.

As I have indicated to you, because of my activities in the either famous or infamous Gang of Six, I am going to have to leave in about half an hour for another meeting that I cannot avoid, and so I am going to miss probably a lot of the testimony. So I am going to try to identify a few areas of concern in my remarks and also ask that I could submit questions as well following the hearing for responses. I do believe that the issues we are dealing with today are critical.

We must continue to think strategically about which areas of the market pose the greatest risk and which areas of potential improvement hold the greatest benefit for investors. The objective should be to apply the taxpayer resources in a way that provides the biggest investor protection bang for the buck.

In addition to these important issues, I look forward to hearing from our different Division Directors of the SEC on Dodd-Frank implementation questions on ways to promote capital formation.

With regard to capital formation, today the SEC is holding two panel discussions on the issue, and one focuses on current capital formation issues for private companies and another on initial public offerings and securities regulation involving smaller public companies.

There are several, in my opinion, unnecessary restrictions on capital formation in both categories that should be removed. The House recently passed some targeted bipartisan capital formation legislation that makes it easier for private companies to raise capital, and there have also been recently two reports that make recommendations on how to reverse the initial public offerings decline.

To stimulate the IPO market and spur more job creation, the recent President's Council on Jobs and Competitiveness Interim Report recommends that Congress amend Sarbanes-Oxley to allow shareholders of public companies with market valuations below $1 billion to opt out of at least Section 404 compliance if not to all of the requirements of Sarbanes-Oxley; or, alternatively, exempt new companies from SOX compliance for 5 years after they go public.

The IPO Task Force recommends providing an on ramp for emerging growth companies using existing principles of scaled regulation. The IPO Task Force expects scaled regulation and disclosure to reduce internal and external compliance for such companies by 30 percent to 50 percent. Both of these recommendations could result in a larger supply of emerging growth companies going public and increased job creation over the long term.

With regard to Dodd-Frank Act, in addition to removing unnecessary restrictions on capital formation, we have to be careful that new rules being implemented under Dodd-Frank give sufficient consideration to how they are going to impact Main Street and the economy as a whole, how they interact with each other, and how they impact our global competitiveness. I am interested in what steps you are taking to ensure that the rules the agency adopts under Dodd-Frank Act are supported by rigorous economic analysis and how you will resolve inconsistencies in the approaches taken by different regulators.

Yesterday, the House Subcommittee on Capital Markets approved four targeted bills to modify Dodd-Frank. One of the measures that passed by a voice vote would prohibit the SEC and CFTC from requiring that swap execution facilities have a minimum number of participants or mandating the display or delay of bids or offers for any period of time. This is in line with the SEC approach, which is more principles based and is in general far less prescriptive than that of the CFTC.

In June, this Subcommittee held a hearing on swap execution facilities. One of the results of the hearing was that there was bipartisan agreement that the SEC and the CFTC need to provide greater coordination and harmonization to get the rules right. As many of you probably know, I am one of those who thinks we should merge the SEC and the CFTC, but until we can get into that discussion, I will encourage that they at least coordinate and harmonize their regulatory activities.

The CFTC should know that Congress is going to closely monitor how they proceed, as well as the SEC, and that we expect this kind of harmonization and a change in course when the agencies begin to divert so that we can have the kind of seamless regulatory system that does protect investors and achieve the objectives that the Chairman pointed out, as he described the hope that all of us have as to how you and other regulatory agencies will operate.

There will be other issues I would like to raise, Mr. Chairman, in my questions, but, again, at this point I will wait, and we can get to the witnesses. And when I have to step out, I apologize. I will be paying very close attention not only to your opening statements but also to your responses to the questions that we provide.

Thank you again for being here.

Chairman REED. Thank you very much, Senator Crapo.

Let me introduce the witnesses. We are extraordinarily fortunate today to have the key leaders of the Securities and Exchange Commission staff.

First let me introduce Mr. Robert Khuzami. Mr. Khuzami is the Director of the Division of Enforcement of the U.S. Securities and Exchange Commission. As Director, Mr. Khuzami is responsible for the civil law enforcement efforts of SEC personnel located in 12 offices across the country. Prior to his tenure at the SEC, Mr. Khuzami served as General Counsel for the Americas at Deutsche Bank AG and before that as the bank's global head of litigation and regulatory investigations. From 1990 through 2002, Mr. Khuzami was a Federal prosecutor with the United States Attorney's Office for the Southern District of New York, where he prosecuted a wide range of crimes, including narcotics, money laundering, extortion, bank robbery, firearms, and tax, bank, and immigration fraud. During his service Mr. Khuzami also help the position of chief of the Securities and Commodities Fraud Task Force. Thank you, Mr. Khuzami.

Eileen Rominger is the Director of the Division of Investment Management at the U.S. Securities and Exchange Commission. Ms. Rominger was sworn in by Chairman Mary Schapiro on February 16, 2011, and is responsible for developing regulatory policy and administering the Federal securities laws applicable to investment advisers and funds. Prior to becoming the investment management Director, Ms. Rominger was with Goldman Sachs Asset Management as the chief investment officer responsible for managing that company's core portfolio teams, including fixed income, equity, and quantitative strategies. She previously worked for 18 years at Oppenheimer Capital, where she was a portfolio manager, managing director, and a member of the executive committee.

Ms. Meredith Cross is the Director of the Division of Corporation Finance at the U.S. Securities and Exchange Commission. Prior to joining the staff in June 2009, Ms. Cross was a partner at Wilmer Hale in Washington, DC, where she advised clients on corporate and security matters and was involved with a full range of issues faced by public and private companies in capital raising and financial reports. Ms. Cross also worked in the Division of Corporation Finance prior to joining Wilmer Hale, serving in various capacities, including as chief counsel and deputy director.

Robert W. Cook is the Director of the Division of Trading and Markets at the U.S. Securities and Exchange Commission. Mr. Cook has served in this position since January 4, 2010. Prior to joining the Commission, Mr. Cook was partner at the law firm of Cleary, Gottlieb, Steen & Hamilton where he was an expert on broker-dealer and market regulation.

Carlo di Florio became the Director of the Office of Compliance Inspections and Examinations on January 25, 2010. Prior to joining the Commission, Mr. di Florio was a partner in the financial service regulatory practice at PricewaterhouseCoopers. While in private practice, Mr. di Florio was one of Pricewaterhouse's national leaders in corporate governance, enterprise risk management, and regulatory compliance and ethics. He has also led numerous fraud and corruption investigations nationally and internationally.

And, finally, Dr. Craig Lewis is the Director and Chief Economist at the Division of Risk, Strategy, and Financial Innovation. Dr. Lewis has served in this position since June 2011. As the Madison S. Wigginton Professor of Finance at Vanderbilt University's Owen Graduate School of Management, Dr. Lewis has taught corporate finance and economics since 1983 and has been on the faculty at Vanderbilt since 1986. In addition to teaching, Dr. Lewis has published research on volatility in stock and futures markets, margin adequacy, corporate earnings management, corporate financial policy, executive compensation, select disclosure, and herd behavior by equity analysts. Thank you.

Your written testimony has already been submitted. It is part of the record. I would ask each of you to take 5 minutes and make an oral presentation, starting with Mr. Khuzami.

STATEMENT OF ROBERT KHUZAMI, DIRECTOR, DIVISION OF ENFORCEMENT, SECURITIES AND EXCHANGE COMMISSION

Mr. KHUZAMI. Thank you, Chairman Reed, Ranking Member Crapo. My name is Robert Khuzami. I am Director of the Division of Enforcement. Thank you for the opportunity to testify today concerning the management and structural reforms at the SEC.

When I arrived at the SEC in early 2009 to lead the enforcement Division, the United States was struggling to come to terms with the impact of the financial crisis. Our job, indeed our challenge at the Division of Enforcement was to investigate and hold accountable those who contributed to the financial crisis, and we took that challenge head on. We immediately set to work investigating conduct that may have contributed to the financial crisis, and at the same time launched an ambitious plan to reform the organizational structure of the Division so that we could work smarter and more efficiently than we had in the past.

Through hard work and innovation, we have completed what was the most significant restructuring in the history of the Division of Enforcement. And although the conventional wisdom was that the dislocation caused by such significant organizational changes would undermine our productivity, that, in fact, did not happen.

In fiscal year 2011, we filed a record 735 enforcement actions, more than ever filed in a single year in the history of the Securities and Exchange Commission. Those actions included 57 insider trading actions, a nearly 8-percent increase over last year's total; 146 enforcement actions related to investment advisers and investment companies, a single-year record and 30-percent increase over fiscal year 2010; and 112 enforcement actions related to broker-dealers, a 60-percent increase over last year. And our focus on financial crisis cases has continued. During the last 2½ years, we filed 36 separate financial crisis-related actions against 81 defendants, nearly half of whom are CEOs, CFOs, or other senior corporate officials, and obtained nearly $2 billion in financial sanctions. This includes actions against Goldman Sachs, Citigroup, and senior executives at Countrywide, New Century, and American Home Mortgage.

And equally and perhaps more importantly, our record number of cases include many involving highly complex transactions, products, and market practices. In the past fiscal year, we filed actions against JPMorgan for misleading investors in CDOs as the housing market began to plummet; Wachovia for misconduct in the sale of two CDOs tied to the performance of residential mortgage-backed securities; two firms involved in the sale of unsuitable CDOs to five Wisconsin school districts; and charges against six executives at Brooke Corporation and three executives at IndyMac for misleading investors about their financial condition.

In addition, to deprive the wrongdoers of unjust profits and to deter future misconduct, we obtained judgments totaling $2.8 billion in disgorgement and penalties this year, which was a 176-percent increase over previous years. And we have also distributed nearly $3.6 billion in disgorgement and penalties in the last 2 years to harmed investors.

And at the same time we were doing this, we instituted the large organizational changes in our division. We flattened our management structure. We revamped the way we handled tips and complaints. We facilitated the swift prosecution of wrongdoers through a formal program that encourages individuals and companies to cooperate in SEC investigations, and created five national specialized units focused on priority areas involving high risk. We have also hired many industry experts, non-lawyers with genuine market expertise and specialized experience, to assist in our investigation. So today, if someone is testifying in an SEC investigation about, for example, improper bond valuations, there is a good chance that sitting across the table from them on the SEC's side of the table is someone who used to value bonds for a living. And one cannot overestimate the clarity and candor that that kind of expertise brings to witness testimony.

We are also focused on thinking creatively and proactively to find emerging threats, stopping frauds earlier before they become more destructive. So using investment advisers as an example, we are now reviewing registration documents for high-risk advisers to determine who lies about things like their education or their business affiliations or their assets under management, under the theory that if they come face to face with an enforcement authority early on, for relatively small matters, they are going to know that we are watching, and they are going to be less likely to graduate to bigger frauds.

We are reviewing mutual fund fee arrangements by analyzing data bases to find those funds that exhibit poor performance, high fee arrangement, and sub-advisory arrangements, all of which might suggest excessive fee arrangements and inadequate oversight.

We have a cross-border working group using risk factors such as language fluency and the extent of use of overseas auditing affiliates and oversight capability of audit firms to identify those U.S. audit firms with foreign clients that may be engaged in financial reporting violations.

As a result of our focus on initiatives and our proactive strategies and our hiring of experts, we are now better equipped to stop fraud sooner. But to continue to innovate, our resources need to keep pace with our responsibilities. We have achieved these results in light of relatively flat budget amounts that have constrained our ability to backfill slots, to hire administrative staff, and to upgrade IT. And we need those resources to continue those efforts, but with that and our new ideas and our new structure, I think we will continue to be aggressively prosecuting fraud.

Thank you.

Chairman REED. Thank you very much.

Ms. Cross.

STATEMENT OF MEREDITH CROSS, DIRECTOR, DIVISION OF CORPORATION FINANCE, SECURITIES AND EXCHANGE COMMISSION

Ms. CROSS. Good morning, Chairman Reed and Ranking Member Crapo. My name is Meredith Cross, and I am the Director of the Division of Corporation Finance at the SEC. I am pleased to testify today along with my fellow Directors on behalf of the Commission to discuss the Division's activities and responsibilities and the challenges that lie ahead.

The Division of Corporation Finance's core functions are reviewing company filings, making rulemaking recommendations to the Commission that relate to corporate finance matters, and providing interpretive advice to the public about the securities laws and corresponding regulations for corporate finance matters. With a staff of approximately 470, we are responsible for the review of nearly 10,000 reporting companies, including tens of thousands of disclosure documents each year, plus initial public offerings and other public capital markets transactions of corporate issuers, public asset-backed securities offerings, and proxy statements, public mergers, acquisitions, and tender offers.

Approximately 80 percent of the staff of the Division is assigned to the review function. The Sarbanes-Oxley Act requires the Commission to review disclosures, particularly the financial statements, of Exchange Act reporting companies at least once every 3 years and more frequently where circumstances warrant. This is no small task.

Following enactment of the Sarbanes-Oxley Act in 2003, the Division revised its review program to meet the new review mandate and hired significant numbers of new staff accountants, which has enabled us to meet the review mandate each year.

We also review the disclosures of many companies more often than once every 3 years. For example, the largest companies are reviewed more often and the largest financial institutions currently are reviewed continuously on a real-time basis.

Corporation Finance has been working to enhance the disclosure review program, including by increasing the focus on large and financially significant registrants, and achieving additional efficiencies in our reviews of smaller companies. Our increased focus on larger and financially significant companies requires greater resources than traditional disclosure reviews, and our ability to implement these enhancements turns on whether we are able to allocate sufficient resources, balancing all other demands on the Division and our staff.

During the 2011 fiscal year, the Division established three new offices: the Office of Structured Finance, which focuses on disclosure reviews and policymaking for asset-backed securities; the Office of Capital Markets Trends, which evaluates trends in securities offerings and the capital markets to determine whether our rules, regulations, and review approach are adequately addressing them; and a new Review Group in Disclosure Operations that focuses on the largest financial institutions.

The Division has staffed these offices almost entirely by transferring existing staff to them. If resources permit, we plan to hire to fully staff these offices to enable them to carry out their intended work.

Corporation Finance also recommends new rules or changes to existing rules to the Commission to address areas in need of change. The Division's recent rule-writing activities have focused on asset-backed securities, corporate governance disclosure-related matters, and Dodd-Frank Act implementation.

Corporation Finance is responsible for preparing a wide variety of rules to implement a significant number of Dodd-Frank Act requirements. These include, for example, rules for corporate governance and executive compensation, including say-on-pay and golden parachutes; disclosure of pay versus performance, pay ratios, and employee and director hedging policies; and listing standards for compensation committees and compensation consultants, and for clawbacks of erroneously awarded compensation; also, specialized disclosure rules for conflict minerals, mine safety, and payments to governments by resource extraction issuers; regulation of asset-backed securities; and revisions to the definition of "accredited investor" and disqualification of offerings involving "bad actors" from relying on Rule 506 of Regulation D.

Finally, at Chairman Schapiro's request, the Division is undertaking a significant new initiative to look for ways to reduce regulatory burdens on small business capital formation in a manner consistent with investor protection. Topics included in this project include: the triggers for public reporting, generally known as the "500 shareholder rule"; restrictions on communications in private offerings, in particular the restrictions on general solicitation; restrictions on communication in public offerings; and new capital-raising strategies such as crowd funding and the scope of our existing rules that regulate capital raising.

Thank you again for inviting me to appear before you today. I would be happy to answer any questions you may have.

Chairman REED. Mr. Cook, please.

STATEMENT OF ROBERT COOK, DIRECTOR, DIVISION OF TRADING AND MARKETS, SECURITIES AND EXCHANGE COMMISSION

Mr. COOK. Good morning, Chairman Reed and Ranking Member Crapo. My name is Robert Cook, and I am the Director of the Division of Trading and Markets, and it is a pleasure to appear here today with my colleagues from the Commission staff.

The Division of Trading and Markets is responsible for developing rules and standards for our markets and market intermediaries, including securities exchanges, alternative trading systems, broker-dealers, clearing agencies, transfer agents, and self-regulatory organizations, such as FINRA and the MSRB.

The exponential growth in the size and complexity of the U.S. securities markets in recent years has created special challenges for the Division's mission. In the past year, the Division has focused on several key initiatives to improve the oversight and function of our equity markets. The Commission adopted a new rule to ban naked access arrangements under which broker-dealers would provide certain customers with unfettered access to the securities markets without any controls to protect market stability and integrity.

Second, the Commission adopted large trader reporting requirements that will help identify and obtain trading information on the largest participants in the U.S. securities markets.

Third, we are preparing a recommendation to the Commission for a rule to create, implement, and maintain a consolidated audit trail to address significant shortcomings in the agency's present ability to collect and monitor trade data in an efficient and scalable manner.

Fourth, the Division has worked on the implementation of several key regulatory initiatives to address significant market volatility such as occurred on May 6th of last year. These initiatives include a uniform single stock circuit breaker program designed to halt trading in a disorderly market. We have also coordinated proposed SRO efforts to implement a limit-up/limit-down functionality for equity markets that will help prevent trades outside specified parameters while allowing trading to continue within those parameters. In addition, the Division has assisted the SROs in the preparation of proposed updates to the existing marketwide circuit breakers.

The Division's core functions have expanded substantially in the past year under the Dodd-Frank Act. All told, the Division is primarily responsible for 27 separate rulemaking initiatives, of which the Commission has published 21 for public comment. The Division is also substantially involved in 12 studies, of which 7 have been completed.

Most notably, we have been charged with the responsibility for developing the registration and regulatory regime for participants in the security-based OTC derivatives markets, including data repositories, dealers, major participants, execution facilities, and clearing agencies.

Going forward, this will mean that Trading and Markets, in coordination with the other Divisions and Offices, will be registering these new entities, monitoring market developments, and promulgating new rules or modifications and guidance where needed.

To date, the Commission has proposed 13 rules related to OTC derivatives. Once the proposal phase is complete, the Division is planning to recommend the Commission seek public comment on an implementation plan that will facilitate a rollout of the new requirements in a logical, progressive, timely, and efficient manner that minimizes unnecessary disruption and cost to the markets.

The Division is responsible for many other aspects of the Dodd-Frank Act, ranging from rules related to proprietary trading activities of broker-dealers—the Volcker Rule; enhanced oversight of financial market utilities, such as clearing agencies; and new procedural requirements for processing proposed SRO rule changes. Pending the creation of new offices for credit rating agencies and municipal securities, the Division is also continuing to work with OCIE to carry out our existing functions in these areas, including the preparation of rules required by the Dodd-Frank Act.

In conclusion, the Division's workload is dominated by a diverse range of functions that are vital for protecting investors and markets, and the scope of these functions has expanded tremendously under the Dodd-Frank Act. Many of our current initiatives will extend well into 2012 and beyond.

Thank you for inviting me to be here today, and I look forward to answering your questions.

Chairman REED. Thank you very much.

Ms. Rominger, please.

STATEMENT OF EILEEN ROMINGER, DIRECTOR, DIVISION OF INVESTMENT MANAGEMENT, SECURITIES AND EXCHANGE COMMISSION

Ms. ROMINGER. Chairman Reed, Ranking Member Crapo, Members of the Subcommittee, let me join my colleagues from the Commission in thanking you for the opportunity to testify today. My name is Eileen Rominger. It has been 9 months since I joined the SEC as Director of the Division of Investment Management. Before coming to the Commission, I had over 30 years of experience in the asset management industry as a portfolio manager and as a manager of portfolio teams.

The Division assists the Commission in its oversight and regulation of America's $43 trillion investment management industry. In doing this, we administer the Investment Company Act of 1940 and the Investment Advisers Act of 1940. We oversee and develop regulatory policy for investment advisers and funds.

The Division has devoted the last year to implementing the provisions of the Dodd-Frank Act as they relate to investment advisers. The Dodd-Frank Act significantly changed the regulatory landscape for these entities.

First, it increased the statutory threshold for SEC registration from $25 million to $100 million in assets under management.

Second, it eliminated a registration exemption for advisers to hedge funds and other private funds.

And, finally, it requires advisers that are not registered to submit reports to the Commission.

As a result, advisers that do not meet the new asset threshold may have to withdraw their registration with the Commission and register instead in their home States.

Advisers to hedge funds and other private funds will be required to register with the Commission or to qualify for one of the narrower exemptions added by the Dodd-Frank Act.

In June, the Commission adopted rules to implement these changes. We anticipate adding approximately 750 new private fund advisers to the SEC registrant pool, but we estimate an overall decline of about 28 percent in adviser registrants overall.

Under new rules, registered advisers will report more detailed information about their operations, including information about the private funds they manage. This will allow us for the first time to obtain much needed information about private funds, such as hedge funds. Following the implementation of these rules, I anticipate that the Division will shift more work to its disclosure, interpretive advice, and exemptive relief programs.

Another important area we are working on is to implement the requirements of the Dodd-Frank Act that concern systemic risk reporting. The Dodd-Frank Act mandated that the Commission require private fund advisers, including advisers to hedge funds and private equity funds, to report information about the private funds they manage for FSOC's systemic risk assessment. Just recently, the Commission adopted a rule that requires registered investment advisers managing at least $150 million in private fund assets to report systemic risk information on a new form called "Form PF." The initial stages of this reporting will begin next year for some of the very largest private fund advisers.

The Division is also working on a number of important initiatives in other areas outside of its Dodd-Frank agenda, one of which I will highlight. Prior to my arrival at the SEC and in response to the run on money market funds during the financial crisis, the Commission adopted important reforms in the area of money market fund regulation. These reforms included a requirement for money market funds to report detailed portfolio holdings information on a monthly basis. Using this data, the Division is able to monitor and discuss trends and any associated risks in these funds with the Commission and with FSOC member staff.

Given the structural fragilities that remain in money market funds, despite the Commission's reforms, the Division continues to consult with FSOC member staff on additional regulatory reform steps.

In addition to our role in Commission rulemaking, a large part of our administration of the Investment Company Act and the Investment Advisers Act consists of providing legal guidance in the form of interpretive and no-action letters, as well as exemptive relief from the provisions of both acts. We also review filings of investment companies in order to both monitor and enhance compliance with disclosure and accounting requirements. Pursuant to the requirements under the Sarbanes-Oxley Act of 2002, the Division reviews the annual reports of all investment companies no less frequently than once every 3 years.

The Division also provides legal and policy guidance to the Division of Enforcement on enforcement matters concerning the investment management industry.

Again, thank you for the opportunity to testify today. I am happy to answer any questions you may have.

Chairman REED. Thank you very much.

Mr. Lewis, please.

STATEMENT OF CRAIG LEWIS, DIRECTOR, DIVISION OF RISK, STRATEGY, AND FINANCIAL INNOVATION, SECURITIES AND EXCHANGE COMMISSION

Mr. LEWIS. Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee, my name is Craig Lewis, and I am the Chief Economist and Director of the Division of Risk, Strategy, and Financial Innovation. Thank you for the opportunity to testify on behalf of the Securities and Exchange Commission regarding the Division's operations, activities, and challenges.

I joined the Division as Director in June of this year. Before coming on board, I was a professor of finance at the Owen Graduate School of Management at Vanderbilt University where I focused on research and teaching, primarily in the area of corporate finance. I am also a Ph.D. economist.

The Division was created as part of the agency's modernization initiative to share expertise and bring together critical data from across the agency. It was established in September 2009 to provide the Commission and its staff with sophisticated analysis that integrates economic, financial, and legal expertise. RiskFin provides economic analyses as part of the Commission's rulemaking process and supports its rule review, examination, and enforcement programs with data-driven, risk-based analytical models. It also oversees the Commission's TCR and interactive data programs. The Division has been especially focused on the agency's increased use of computerized risk analysis and data sharing.

The Division participates in the rulemaking process by helping to develop the conceptual framing for and assisting in the subsequent writing of the economic consequences of the rules the Commission promulgates. Where appropriate, the SEC considers, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation when engaged in rulemaking.

Economic analysis of agency rules considers the key economic effects of the various alternatives that should be considered in developing regulations. Analysis of the likely economic effects of proposed rules, while critical to the rulemaking process, can be challenging. Certain costs or benefits may be difficult to quantify or value with precision, particularly those that are indirect or intangible. The Division is committed to continuously improving economic analysis in Commission rulemakings and to the integration of RiskFin economists into the rulemaking process. While the Division is striving to fully comply with these increased demands, it faces challenges in its ability to do so given current resources.

The second core function of the Division is to administer a number of data-driven responsibilities and initiatives. For example, the Division currently provides economic and statistical analysis to support all aspects of enforcement and litigation matters for the Commission. It also has developed innovative software tools and uses cutting-edge analytic methods to identify problem areas associated with investment managers.

The interactive data program provides information contained in certain documents filed with the Commission in a structured format that makes the underlying data readily available for analysis. The Division has a number of responsibilities that include promoting the use of interactive data, developing infrastructure, and supporting rule writing to implement data-tagging requirements.

To improve efficiency, the Division has been reorganized to reassign staff that have expertise in data analysis and risk assessment into the newly formed Office of Quantitative Research, which will be responsible for designing quantitative risk management models.

This office has begun to build a data infrastructure to facilitate the development and support of analytics.

Going forward, the Division would like to expand its capabilities to developing risk assessment models and to build a scalable data infrastructure to support risk-based initiatives. Although the Division plans to pursue these objectives and has existing employees with the necessary expertise to work on these projects simultaneously, resource constraints inhibit progress and significantly slow the rate of innovation. For example, a project to develop a model to detect accounting fraud has been delayed due to resource constraints.

While the Division has made significant progress since its inception in 2009, the scope of its responsibilities has been significantly expanded as it continues to find new ways to assist other Divisions and address the additional obligations that have been mandated by the Dodd-Frank Act.

Thank you for inviting me to share with you the work of the Division of Risk, Strategy, and Financial Innovation. I look forward to answering your questions.

Chairman REED. Thank you very much.

Mr. di Florio, please.

STATEMENT OF CARLO V. DI FLORIO, DIRECTOR, OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATION, SECURITIES AND EXCHANGE COMMISSION

Mr. DI FLORIO. Good morning, Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee. Let me join my colleagues in thanking you for the opportunity to testify today on behalf of the U.S. Securities and Exchange Commission. My name is Carlo di Florio, and I am the Director of the Office of Compliance Inspections and Examinations. As you noted, I joined the Commission on January 25, 2010, prior to which I was a partner in the financial services regulatory practice at PricewaterhouseCoopers in New York.

Since joining the SEC, I have enjoyed working with colleagues who are so dedicated and committed to furthering the SEC's important mission. The SEC's National Exam Program helps protect investors and ensure market integrity by examining for fraud, monitoring risk, promoting compliance, and ensuring market integrity, and informing the SEC as the eyes and ears of the Commission in the field.

Our exams assess whether registrants are treating investors fairly and complying with the securities laws and regulations that are designed to protect investors and prevent fraud. The 830 supervisors and examiners in the National Exam Program take a risk-based approach to examining 25,000-plus registrants, including investment advisers, investment companies, broker-dealers, derivatives registrants, hedge funds, mutual funds, credit rating agencies, SROs, national exchanges, clearing agencies, and transfer agents.

Under the direction of the new leadership team, OCIE has undertaken a top-to-bottom review and launched over 20 improvement initiatives to strengthen our strategy, our structure, our people, our processes, and our technology. Accomplishments over the past year include the following:

We have recruited experts and launched new specialty groups that bring deep, needed expertise and specialization in program areas such as derivatives and structured products, hedge funds, credit rating agencies, high-frequency trading, and risk management.

We have conducted over 1,600 exams that are better targeted to preventing fraud, identifying violations, and addressing higher-risk firms, products, and practices.

We have implemented a new large-firm monitoring group to focus on systemic risk firms and a new Risk Analysis and Surveillance Unit to enhance our ability to monitor risk trends and target those firms and practices that present the greatest risk to investors, markets, and capital formation.

We have created a national governance structure that breaks down silos and facilitates coordination, consistency, effectiveness, and accountability across the country.

We have streamlined and automated our exam process with new technology. We have clearly defined expectations in a new exam manual, and we have implemented a new internal compliance and ethics program to monitor our performance and ensure our accountability.

We are working to design and implement a new examiner training program that establishes technical training and certification standards across the country.

No matter how much we improve our current program, however, the fact remains that our 830 examiners and supervisors can only cover a small portion of the 25,000-plus registrants we are responsible for overseeing. This results in a ratio of only one examiner for every 30 registrants.

To give you a sense of benchmarking, bank regulators, for instance, typically have an examiner-to-registrant ratio of 1:1 or 1:2. FINRA's ratio is 1:5. Needless to say, our 1:30 ratio presents an enormous gap with real consequences if not addressed.

For instance, our staff was only able to examine 8 percent of registered investment advisers in fiscal year 2011, although we visited firms with more than 30 percent of the assets under management currently registered with the SEC. In addition, more than one-third of registered investment advisers have never been examined.

We continue to pursue strategies such as risk-focusing our exams and automating our exam processes to be as efficient as possible and to maximize the usage of resources we are provided. Nevertheless, additional resources would enable us to more effectively fulfill our new responsibilities, protect investors, and ensure market integrity.

Thank you, and I welcome the opportunity to answer your questions.

Chairman REED. Thank you very much. I want to thank all the witnesses for superb testimony, and your collective testimony illustrates the range, the complexity, and the vital importance of what you do, and also I think underscores the need to be properly resourced to do a very complicated job, which gets complicated each and every day by innovations in the marketplace. So thank you very much again for what you are doing and what you continue to do.

I think, you know, one final point on this area, if you do not have these resources, you cannot effectively provide sort of direction and guidance in the marketplace. Perhaps Professor Lewis can comment. It is probably more inefficient than anything else that you are not giving them the guidance that they need to go forward and make appropriate decisions.

Let me begin my questioning, and I am in an enviable position because I have lots of questions and I have experts before me. Mr. Khuzami, one of the most notorious incidents of the last few years was the Madoff scandal. Recently, the final act, perhaps, has been undertaken, which is the disposition of allegations against members of the SEC, their behavior. There were some people in the Enforcement Division involved. There have been sanctions, but no one has been dismissed, and that is a question which is at the forefront of many people's minds, accountability. You are asking for accountability in the marketplace. I think the American public is also asking through us accountability at the SEC. Can you comment on the disposition and whether or not you feel that was appropriate?

Mr. KHUZAMI. Yes, Senator. I think you are absolutely right that accountability is our obligation as well, and with respect to not only the Madoff matter in general, which has spawned and generated many of the forward-looking reforms and changes and organizational revisions that you have heard this morning with respect to individualized disciplinary decisions, the Inspector General's report identified a total of 21 persons, approximately, who he believed warranted follow-up for possible disciplinary actions. About 10 of those left the Division since the report was issued, and the SEC has no ability to discipline ex-employees who have departed. So that left approximately 11, and we conducted an extremely thorough process to make these decisions, including bringing in an independent law firm to conduct its own independent investigation and then make recommendations to the proposing and deciding officials, because ultimately it is an agency decision.

Of the 11 persons who remained, 9 were recommended for actions by the law firm, and action was, in fact, taken against all 9. In a couple of cases, it was—I think in two cases perhaps—less than what the law firm had recommended, and I will defer to Mr. di Florio, as I think the individual who the proposal was should be terminated was in the OCIE program. In fact, a different result was achieved. But, generally, all the persons recommended by the outside law firm suffered a range of discipline.

Chairman REED. Mr. di Florio, can you comment? Then I have a follow-on question.

Mr. DI FLORIO. Sure, Senator. As my colleague Mr. Khuzami noted——

Chairman REED. Is your microphone on?

Mr. DI FLORIO. Yes. Are you able to hear me OK? As my colleague Mr. Khuzami indicated, a very serious review was undertaken, and all of the individuals ultimately that were identified were disciplined. In one instance, the independent third-party law firm recommended termination of an individual or, if termination would have a significant negative impact on the operations of the SEC, then to fashion an alternative remedy that would significantly change that individual's roles and responsibilities, such as a demotion and a reduction in pay. So the SEC staff followed that recommendation of the independent law firm and refashioned the roles and responsibilities of that individual. The individuals no longer have supervisory responsibilities. Their role was reduced. The individual received a reduction in pay, and there was a suspension of 30 days.

I would also just assure the Congress and the American people that we have taken the lessons learned from Madoff very seriously and have implemented significant improvements to help us identify and prevent fraud so we can better protect investors, ensure market integrity, and facilitate capital formation.

Chairman REED. Could you just follow up very quickly on some of the steps you have taking looking forward based upon the experience with Madoff?

Mr. DI FLORIO. Sure. We have undertaken significant training for all examiners and investigators in the SEC of fraud techniques, fraud tools, and we have made sure that our forces truly understand the various fraud scenarios that are out there, how to identify them, and how to act quickly to shut them down. I think our results, as articulated by Mr. Khuzami and some of the results that I identified, demonstrate how we are beginning to have that impact. In addition, we have really brought technology to bear. We have a new system for tips, complaints, and referrals that centralizes any such tips, complaints, and referrals that come in and make sure that we have the right people triaging it and following up on it. We are bringing better technology, better resources, better people to the job.

Chairman REED. Thank you very much.

Mr. Khuzami, let me return to another topical issue. Judge Rakoff has raised some questions about the appropriateness of a settlement that you have proposed with Citicorp, but it raises a few questions. One is you have allegations against the company, but there are no individuals that have been, I think, pursued in this case and other cases. And to a lot of people on the street, they are wondering how a company can commit serious violations of securities laws, and yet no individuals seem to be involved and no individual responsibility is assessed. And that, I think, it at the heart of one of the concerns that Judge Rakoff has. Can you comment on that?

Mr. KHUZAMI. Sure, Senator. We focus first and foremost on individuals for exactly the reason you identify: individuals commit wrongdoing, not institutions. But I think it is a misperception that we have not charged individuals.

First of all, in the Citicorp case itself, we charged the individual who was responsible for the particular transaction, and we are in litigation now with him. We also charged a second individual who worked for the collateral manager on the deal, the firm that represented that it was independently selecting the portfolio when, in fact, that was not the case. So two individuals were charged in this case. And, overall, across our credit crisis cases, just to take an example, as I mentioned in my opening remarks, in approximately 26 cases 89 individuals and entities, half of which are high-ranking corporate officers, have been charged. The entirety of the executive suite at New Century and IndyMac and other companies and individuals who have sold these deals have been charged.

I think part of the concern is that why hasn't—and some of these cases have gone all the way up to the executive suite, and why haven't the heads of banks been charged? But it is a difficult challenge in certain transactional cases because what is going on occurs, you know, two, three, and four levels below the executive suite. If you are selling a CDO, it is being put together by individuals working on the desks, and the disclosure is being written by individuals who are not at the executive level. So the evidence and the duties and obligations do not always rise all the way up to the top of the executive suite, unlike, say, in accounting fraud or financial statement fraud where CEOs and CFOs and others may have to sign off on the accuracy of financial statements.

So to some degree, if that is the concern, it is a function of the nature of the cases, but we have aggressively charged, as I said, over half of the individuals in these cases, 40 to 50 high-ranking CEOs, CFOs, and senior corporate executives.

Chairman REED. Let me follow up with one additional question before I recognize Senator Merkley and then Senator Menendez. You are, of course, talking about civil charges, which is your responsibility, but there have been many other commenters who have raised the issue of why aren't there any criminal charges because there are at least suggestions or allegations of criminal violations as well as civil violations. And as I understand it, you would have to refer those cases to the Department of Justice. But the record is not—there are very few that I can think of criminal cases that have been taken in the wake of the worst financial crisis in the history of the country, and behavior which, at least to the outside observers, seems to be highly questionable.

Have you been making referrals and has Justice been systematically turning you down? Or how can you comment on this relationship?

Mr. KHUZAMI. Senator, we work extremely closely with the Justice Department and with the U.S. Attorney's Office in New York and other offices, and I can assure you that they are keenly interested in cases arising out of the credit crisis and looking extremely closely at the evidence in these matters, conduct their own inquiries, and reach their own determinations.

It is a hurdle for them. They have a higher standard of proof in a criminal case. They must prove a case beyond a reasonable doubt. And so some of the challenges that we face, they face even more forcefully because of that higher standard of proof. But I can assure you it is not for lack of dedication or professionalism or talent that criminal cases are not being filed.

Chairman REED. I presume from that answer that you have made referrals, but they have not been followed through because of the judgments they have to make independently.

Mr. KHUZAMI. Well, yes, it is referrals, but it is also—we work very closely with them. We do not just take a case and refer it over to them and wash our hands of it. We are in constant communications and discussions and reviewing evidence and working collaboratively.

Chairman REED. Thank you very much. There will be an additional round of questioning, but let me recognize Senator Merkley now for his statement or questions or a combination of both.

Senator MERKLEY. Thank you, Mr. Chair. I do not have a statement, but I do have some questions, if that is appropriate. Thank you.

I wanted to start to get anyone's opinion on Congressman DeFazio's proposal on high-frequency trading, which goes back to kind of thinking a little bit about the "flash crash." I believe what he had in his most recent proposal is a 3-basis-point fee that discourages, if you will, the multitudinous high-speed trades while having very little impact on regular investors.

Any thoughts about that? Mr. Cook.

Mr. COOK. Thank you, Senator. I am not familiar with the details of that, but I think that proposal or versions of it have been raised several times, and I think there are a number of interesting issues that it raises. Obviously, there are concerns about the extent to which the traffic that is generated by high-frequency trades is of itself interfering with the effective functioning of the markets, and to some extent some type of fee, whether it is a message fee or an order cancellation fee—there are various versions this might take—that might be helpful in addressing that.

I think the challenges are, first, picking the right metrics for when that would happen, when it would kick in, what the type of fee would be; and second, and probably more importantly, to not undermine the liquidity in the markets that may be very important, and certainly during normal market circumstances. Given the prevalence of high-frequency trading in our markets today, I think this is an area where we would have to move very carefully to ensure that whatever changes we introduce to a significant portion of the volume in the markets is carefully considered to avoid any unintended consequences.

Senator MERKLEY. Does anyone else want to weigh in on that?

[No response.]

Senator MERKLEY. Very good. Thank you.

The second issue I wanted to get some insights on is the crowd funding of companies. As we move to this Internet world, as people become familiar with peer-to-peer lending, certainly this is a very different avenue than traditional investing, very different for the investors and very different for the companies. And in some ways it is a very exciting possibility, but it also poses risks related to fraud. Any insights on how this gets pursued, supported, or guided so that it will be a win for investors and a win for companies?

Ms. CROSS. I will start off. First off, I have to note that I am not participating in the crowd funding matter because of my prior work for a peer-to-peer lender, but in general, with regard to the new capital-raising strategy ideas that are being considered in Congress and also at the Commission, the key here is to make sure that whatever is built does not become fraught with fraud so that investor confidence is destroyed and then people will not invest in that market since that level of deregulation would not help anyone.

So we are working with the market participants and Members of Congress and looking at the various pieces of legislation to help put in safeguards that would keep that from happening. I think one of the ideas that has been discussed is the possibility of intermediaries as a means of protecting investors, and I can let Mr. Cook address that.

Mr. COOK. So when we think of investors purchasing securities, one of the traditional tools we have to help provide protections for them is the registration and regulation of the party who is doing the selling as a broker-dealer. Some of the factors we think about when we think about whether that is appropriate include: Does the broker have a salesman's stake in the transaction? Are there conflicts of interest that might arise? Is the intermediary handling customer funds and securities?

And so I think, in our experience in this area, I have a couple of observations. One is that fact patterns matter, and there are very different forms in which these intermediaries may relate to investors. And I think in some cases we have given guidance that they are not subject to registration or would not because the regulatory policy concerns have not been triggered.

I think another area that we need to think about, though, is whether we have a sufficiently flexible regime because the types of rules that might be appropriate for one type of entity may not be appropriate for a traditional brokerage house, for example. And I think if there were a regulatory regime in place here, I think that would be a key area in which we would want to have some flexibility to tailor the requirements to the specific facts and circumstances.

Senator MERKLEY. Thank you. My time is up, so I am just going to say I appreciate your feedback on both of those. There are about ten other topics I would be happy to extend the conversation on, but I am going to defer to my colleagues.

Chairman REED. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

Ms. Cross, I authored Section 953(b) of the Dodd-Frank legislation which requires publicly listed companies to disclose the pay of their median worker compared to the pay of their CEO. And we weighed in with the SEC earlier this year about both our intention with this provision and where it is that you were at. We got an answer that was less than satisfactory because it was a nonanswer, as far as I am concerned.

So can you tell me where it is that you are at in terms of being on track for finishing this rule on this provision by the end of this year?

Ms. CROSS. I am happy to do so. Right now the Division is in the process of preparing the recommendation for the Commission so that they can act on a proposal. We are trying mightily to make it by the end of the year. That is the schedule that is up—that is the goal that is up on our public Web site, and I can assure you that we are doing everything we can to get there.

We have a lot of things we are trying to do right now, and this is one of the very important ones. But I can assure you we are trying our hardest to make the year-end.

Senator MENENDEZ. I would hope that what we see happening across the country and people's concern about inequality would spur the SEC to have a mere transparency—we have had testimony here, particularly from those who have come from the private sector, about how hard this will be, and they actually have said that they do not believe that it is that difficult to produce the information. So I hope we understand, particularly in light of actions that are being taken by citizens across this country about how important—I know you have a lot of work. We gave you a lot of work to do. I understand that. But this is something that clearly people are looking forward to have some transparency and to have it sooner rather than later. So we are looking forward to you achieving it by the end of the year, at least bringing it before the Commission.

Ms. CROSS. We are doing our best, as I said.

Senator MENENDEZ. OK. That means you will get it done before the end of the year.

[Laughter.]

Senator MENENDEZ. Let me ask you this as well: Earlier this year I introduced the Shareholder Protection Act with several of my colleagues to disclose corporate spending in elections in the wake of what I believe is a misguided decision on Citizens United. Since then, my staff has been told by SEC attorneys that the SEC already has the authority to implement rules that would require corporations to disclose their political spending to shareholders. Is that accurate?

Ms. CROSS. Yes, it is accurate that the Commission has the authority to require that disclosure, if they decided to do so, through rulemaking. I would note that the Citizens United case has certainly piqued an interest in this topic. We have two rulemaking petitions pending at the Commission right now asking us to consider requiring disclosure about political spending.

I also note that this is an area where the market is moving in that direction as well. A recent report showed that more than half of the S&P 100 is already providing this disclosure. Also, shareholder proposals are included under our rules in proxy statements so that shareholders can vote on whether they want this disclosure. So this is certainly an area of great interest.

The staff is carefully considering all this as we think about the issue.

Senator MENENDEZ. Well, I hope the SEC believes that this type of disclosure would be helpful for investors. An October 2010 Zogby poll of business leaders found that 77 percent of them believe that corporations should disclose all the direct and indirect political expenditures. Is that something the SEC disagrees with?

Ms. CROSS. I cannot speak for the Commission on that point. We have not taken this up with——

Senator MENENDEZ. At the staff level, where are you headed on your recommendations?

Ms. CROSS. We have not concluded what we should recommend. I think we are reviewing the petitions and considering the issue in light of recent developments.

Senator MENENDEZ. Many large companies—Microsoft, Wells Fargo, Merck, Aetna—have already taken steps to disclose their political expenditures, and to me it illustrates the ease in which it can be done. And so I am hoping that the SEC looks for that to be for shareholders across the board a reality. So I am looking forward to what your recommendations are on that as well.

Mr. Cook, let me ask you one quick question. What is the SEC's expected timing for issuing the remaining proposed rules on capital margins, segregation, and record-keeping requirements for security-based swaps under Title VII of Dodd-Frank?

Mr. COOK. The rules you refer to, which are the final rules in the substantive proposal phase of our OTC derivatives regulation, are at the top of the list for our OTC derivatives work. The goal was to get them done by the end of the year. Whether we hit that or not, I am not sure, but that is probably the next item out of the Commission on the OTC derivatives front.

Senator MENENDEZ. So let us say for argument's sake that you reach it at the end of the year. What would be your overall implementation schedule or proposed implementation rules for its final rules?

Mr. COOK. Well, what we propose to do after we propose all the substantive rules is to issue two releases that are also underway now so that we can get them out as quickly as possible. One is a release that discusses how our rules would apply internationally, so a cross-border release, looking across each of the different substantive rulemakings, whether it is execution facilities or dealer registration or clearing agencies, and talk about how those rules apply or would apply in a cross-border context and solicit comment on that, because it is a very important piece of the implementation.

The second thing would be to issue an implementation plan—both of these would be for public comment—that would lay out the process by which we would propose to roll out the new framework in a timely, efficient manner with the goal of approaching this as a project management task where, if we can be as thoughtful in how we roll it out, we will get to the end more quickly and efficiently.

Senator MENENDEZ. All right, Mr. Chairman. Thank you very much. I appreciate it.

Chairman REED. Thank you, Senator Menendez.

Let me begin the second round by asking Mr. Khuzami, again, in the context of this recent litigation under Judge Rakoff with respect to Citicorp—and this is not exclusive to one company, but typically you will reach a settlement in which the corporation neither admits nor denies, and it strikes a lot of people oddly why, if you do not have any culpability, you are paying several hundred million dollars. Have you reconsidered whether or not that is at all effective or what role it plays? That is one question.

The second question would be: They typically also say that they will never do this again, and I am not using the precise language of the finding, and then you find that—and, again, not exclusive to one company but many companies—troubling patterns of behavior emerge in the future, maybe not exactly identical but certainly within the same sort of context of—and yet there does not seem to be action in your Division to take people up on their commitment never to do it again or anything like it again.

Are you rethinking what you can do in terms of these settlements on both those points?

Mr. KHUZAMI. Senator, let me explain our approach in these areas. First, the bottom line is we settle cases where we believe that the sanctions that we can obtain, including the monetary sanctions and the business reforms, *et cetera,* are what we could likely obtain should the case go to trial, taking into account the risks, the strength of the evidence, the law, *et cetera.*

In monetary sanctions, which is another matter that has been discussed, I would make it clear that we cannot obtain penalties in the amount of investor losses. We are limited by law to getting disgorgement, which is the ill gotten gains of the perpetrator, and then a penalty, in general, equal to the amount of that gain. So if you had somebody who earned $20 and defrauded investors of $100, we can get $20, representing the gain of the perpetrator, and another $20, and a penalty, but we cannot get the $100, in most circumstances.

And so to some degree, there has been commentary about our settlements, that they do not seem to be significant enough in terms of the financial sanctions. That reflects, frankly, our view of the strength of the evidence of the case and the risks associated with it, but also some statutory restrictions on the amount of money that we can get.

But in addition to that, with respect to "no admit, no deny," our goal is to get money in the hands of investors as soon as possible. If we were to demand admissions in every case—and keep in mind, it is "no admit, no deny," which means companies cannot deny liability. They are not required to admit it, but they cannot deny liability, as well. And so under that provision, if we were to insist on admissions, because of the collateral consequences of those admissions, both with respect to private civil litigation and even with respect to criminal exposure, companies are not going to open themselves up to that kind of exposure.

Now, I do not have any particular sympathy for that. It is just a reality of the negotiation process that they will not settle cases and they will take more cases to trial. So we are left with a situation in which if we can settle a case now for the amount of money and the range of sanctions that we believe reasonably approximates what we can get if we were successful without the risks of a trial, and most importantly, get money in the hands of investors today rather than 2 years from now or 3 years from now or 4 years from now when that case goes to trial, and even more if it goes to appeal, and most importantly, we added more resources to attack the next fraud, because there are opportunity costs in everything that we do—if we are prosecuting Case A, we are not prosecuting Case B—and so it is cold comfort to victims of other frauds if we are putting all of our resources taking a case to trial and if one is not settling, when their case is not being prosecuted if we are getting a package of remedies that are strong and send a meaningful message.

I would also say that in our cases, we issue a complaint with very detailed allegations. The company pays a large amount of money. They agree to business reforms. They cannot deny liability. My view is, while I certainly understand the desire for people wanting someone to stand up and admit to the wrongdoing, there is not a lot of mystery under those circumstances that the company is, in fact, engaged in wrongdoing. They would not be writing a check for $300 million or agreeing to reform their business in the face of these very pointed and specific allegations of what happened.

So on balance, trying to serve many values, we adopt a "no admit, no deny," like the FTC, like the Department of Justice Civil Division, like the CFTC, and just the other day, the National Credit Union Administration settled the case against two banks for $300 million for mortgage related problems also on a "no admit, no deny" basis and the Supreme Court has endorsed it.

So while I understand the desire for it, and there are cases where I might like to see it, as well, and we do review our policy, the fact of the matter is that we have to choose amongst some competing goals that we are trying to accomplish and that is where we come out.

With respect to repeat offenders, this deals with the question of contempt, and I think there is a little bit of a misperception around our authority in this area. If a company engages in a securities law violation in 2005 and agrees not to do it again by way of an injunction, and then in 2008 sells a securities product that violates the law, we are not able—we can only get civil contempt, but civil contempt is only available if there is an ongoing fraud, so that we could go in court and say, Your Honor, this company is engaging in conduct now that violates their previous promise not to break the law again. You have to stop them from doing this conduct right now. But that only works if the conduct is ongoing. If the sale of the securities is over, there is no ongoing fraud. There is nothing to order compliance with. And that is the vast majority of cases. There has to be ongoing fraud in order to bring a contempt action.

In addition, the most you would get from a judge is he would say, stop doing what you are doing now, but if it is already over, there is nothing to get. I think what most people want in this area is criminal contempt, which is punitive, which is sanctions for simply violating the previous order, and that, only the Department of Justice has authority to do. But we by no means ignore recidivism. We take it into account in deciding how much a company should pay in that second action, what kind of business reforms might need to be adopted, and other packages. So we thoroughly take into account prior misconduct, but contempt is a poor vehicle in most cases to accomplish that.

Chairman REED. I have one quick follow-up question before I recognize Senator Merkley. I promise I will ask the other panelists, when I return, questions.

Recently, you have used language in the Sarbanes-Oxley legislation to claw back gains that an individual received although he was not directly charged with any type of violation. Is that a practice that you are going to pursue with more frequency going forward?

Mr. KHUZAMI. Yes, Senator. That is Section 304 of Sarbanes-Oxley, which allows us to sue and require a CEO or CFO to claw back certain incentive-based bonuses and equity awards as well as certain stock sale profits when the company that they work for fails to comply with certain financial reporting requirements as a result of misconduct, and we have used that tool and we look in all of our cases to whether or not that tool is appropriate. It is a strong tool because, like you say, these are stand-alone actions. The CEO or the CFO does not have to be involved in the misconduct. If the company they are working for does it, their compensation can be clawed back. And so we look at it closely.

It is not without some issues. Obviously, CEOs and CFOs are differently positioned. Some are completely absentee and do not do their job at all and misconduct occurs. Others may be very active, may be even following best practices, and nonetheless misconduct occurs. So you need to exercise a range of discretion in these cases, but it is a tool we look at closely and we have brought a number of actions in this area.

Chairman REED. Thank you.

Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair.

I wanted to turn to MF Global, which, if I understand right, MF Global was both broker-dealers, if you will, regulated by the SEC and a futures dealer regulated by the CFTC. I believe it is on the futures side that the issue of client accounts and the segregation of client accounts is in question, that is, whether their accounts, the money was used in a proprietary trading or hedge fund style operation and in violation of the sanctity of those individual accounts.

So it is very confusing to the public, certainly to us, as to where the oversight comes and what went wrong, but recognizing that the SEC is primarily on the broker-dealer side of the firm, did things go wrong on the broker-dealer side, or is the broker-dealer side deeply impacted, if you will, by the—which I am sure it is—by the futures side? How does the CFTC and SEC coordinate their regulation of this type of complex firm?

Mr. COOK. Senator, as you have noted, the firm was dually registered as both a broker-dealer and an FCM, a Futures Commission Merchant. What that means is that both agencies and the self-regulatory organizations under them have oversight over the firm.

In some respects, our oversight about certain activities would focus on securities and the CFTC's and the DCOs under the CFTC would focus on the futures activities. We both have rules, as well, that would apply to the entity as a whole, for example, capital rules, and the entity would be subject to—have to comply with both sets of rules. So being jointly registered means that you have to comply with the rules applicable to a broker-dealer and the rules applicable to an FCM.

As you noted, the shortfall that has received a great deal of attention in the press and is a significant concern is on the futures side, the segregation of customer assets related to the futures positions. Your question, does that affect the broker-dealer side, I think, of course, it is one entity that is now in bankruptcy and shortfalls are obviously a significant concern in any customer protection regime. We are continuing to work with the trustee, as is the CFTC and other regulatory agencies, to help identify exactly what is the position of the firm, both on the securities side and the futures side, because one of the challenges here is that the books and records of the firm appear to be challenging in terms of getting to the bottom of some of these questions.

I think, just having been in close contact with the CFTC and other regulators through the weekend when the firm was exploring strategic options, absent this shortfall being identified, there would have been a significant chance of a deal happening that would have transferred the customer accounts out in the way it is meant to happen. So if broker-dealers and FCMs fail sometimes, our goal is to make sure if that happens, there is a credible and reliable way to protect customers, and that only works if the customer assets are available to transfer to a new firm. So in that sense, the shortfall obviously impacts all customers.

Senator MERKLEY. So is that happening on the broker-dealer side?

Mr. COOK. You mean, is there

Senator MERKLEY. On the customer—in terms of customers who own stocks or placed orders through the securities broker-dealer side, have their accounts been transferred out to some other firm?

Mr. COOK. Not yet. There were many more futures customers, so I think the trustee has transferred 17,000 futures accounts that had positions in them. There are more that he is seeking to compensate that did not have positions but had collateral.

Just by way of contrast, on the securities side, he has solicited interest in acquiring 450 securities accounts, so it is a much smaller number of affected customers. The trustee has solicited interest from potential transferees of those accounts so that they and their property could move forward.

Senator MERKLEY. So is it likely that the account holders on the broker-dealer side are whole and undamaged?

Mr. COOK. I would not want to provide any assurances at this time. I can tell you that what the firm self-reported was a shortfall on the futures side. The firm's calculations on the securities side with respect to its customer segregation requirements indicated that it was in compliance with the securities customer segregation rules. But as you can imagine, we are not taking that at face value. We are currently working hard to try to verify exactly what is there and who owes what so we can provide assurances.

Senator MERKLEY. The reason—and I am over my time now, so I will just summarize this—the reason I am pushing this point is trying to understand where there are insights here about the complexities of regulating a firm that is both a broker-dealer and a futures dealer, whether there needs to be stronger firewalls between the two halves of the business in order to ensure both the coherence of regulation and the security of one side of the firm, if you will, and the customers from fraud on the other side of the firm. Those were the types of pieces I am pushing, and I will look forward to kind of—maybe my team can continue the conversation with you about insights that can be derived from this.

Mr. COOK. Absolutely.

Senator MERKLEY. Thank you.

Chairman REED. Thank you, Senator Merkley.

Let me resume, and Ms. Cross, Senator Crapo indicated his interest in the formation of capital, particularly for small companies. I know you and your colleagues are working this. Could you let us know your latest efforts in terms of capital formation, particularly the small enterprises?

Ms. CROSS. Absolutely. So at Chairman Schapiro's request, last spring, we started an initiative to take a fresh look at our rules to see if there are steps we could take to reduce regulatory burdens that would help facilitate capital formation by smaller companies, if it could be done consistent with investor protection. As I noted, if investors are not confident, then they are not going to invest and so you do not actually help anyone raise capital. So in everything we do, we try to balance the capital formation mission with the investor protection mission.

The staff has several work streams going right now that are in the works. One is to do a study of whether the 500-shareholder threshold for reporting should be changed. In 1964 when Congress adopted the current 500-shareholder threshold, they had tasked the SEC with doing a robust study, so we are doing that again with help from Craig's group. So that is one of the pieces.

We are working on a concept release on the general solicitation issue in private offerings and we are looking at whether there are ways we can extend some of the benefits that we give to larger companies in capital raising, extend those to smaller companies. For example, access to shelf registration, things like that.

We are being helped tremendously in this effort by our new Advisory Committee on Small and Emerging Companies. It had its first—its kick-off meeting 2 weeks ago and they are already working on recommendations, having considered these topics, which we brought forward to them at the first meeting.

And then tomorrow is our—I think it is the 30th Annual Government Business Forum on Small Business Capital Formation that is being held at the Commission. I think every Commissioner is speaking at it and attending it, so there is obviously great interest in the topic.

Chairman REED. Thank you very much.

Mr. Lewis, you have an increasingly challenging role to play. The relevant legislation requires publication of a rule for the SEC to consider market effects, but given the recent court rulings, it is hard to tell what "consider" means. In fact, there seems to be suggestion now, and at least rhetoric now, that that is sort of a detailed cost-benefit analysis weighing every conceivable option, *et cetera,* which goes far beyond the literal term "consider."

But can you talk about your role in providing that kind of analysis? You alluded to it in your opening remarks. And also, if you have a practical difficulty of getting cooperation from market participants in giving you the data you need, which sort of sets up a catch-22. You cannot do the analysis to promulgate the regulation unless you get cooperation, and you do not get cooperation, so now you are vulnerable for a challenge. Can you comment?

Mr. LEWIS. Yes, Chairman. I would like to comment. As you can imagine, the recent ruling on the proxy access case provides significant challenges to the Division including reassessing the way it conducts cost-benefit analysis. I think the D.C. Circuit Court clearly took issues with the way cost-benefit analysis has been conducted historically at the SEC, and there are lessons, I think.

I think what they are really asking us is to take a look at the way you actually conduct cost-benefit analysis, and the big takeaway from a lot of the recent decisions, in my opinion, is we need to provide a more fulsome discussion of all the various alternatives that are on the table, a fulsome cost-benefit analysis around the proposed rule, but also around viable alternatives to the rule. And part of that will be to provide a complete discussion not only of the costs and benefits that we are able to quantify, but of the qualitative costs and benefits, and that is really one of the rubs in trying to analyze cost-benefit analysis, is that so many of the benefits that are associated with a particular rule simply do not lend themselves to ready quantification and it is really not feasible in a lot of situations.

I think the other take-away from the proxy access decision is that while there is a—currently, the typical practice is to involve the Ph.D. economists at the SEC at very early stages in the rulemaking process, I think we need to formalize that process and bring them in in a more formal, prescriptive way.

Chairman REED. Any comment about access to information from—proprietary information that could be decisive in your analysis?

Mr. LEWIS. Yes. That is one of the challenges we face, because to quantify benefits or costs associated with the rule, you have to avail yourself to data. And if data is not publicly available, many times the only way you can get it is to try to request the data through the comment period process from market participants. And so we, when we propose rules, we frequently will design questions that are designed to give us the data. But as you have mentioned, a real problem with that process, is that, frequently, there are not incentives to provide the data on the part of market participants. So if you do not get that data, it is very difficult to do the subsequent analysis.

Chairman REED. Thank you very much.

I want to begin with Ms. Rominger on this question, but I would like all the panel to weigh in, if appropriate, and that is that so much of what you do depends on sort of having a feel for the marketplace, real time information, data, intelligence, and particularly with your supervision of mutual funds, one of the issues today sweeping across the Atlantic is sovereign wealth funds and who is holding what, *et cetera*. Can you just comment in general terms about how you deal with making sure you have access to the most relevant information in real time to make these judgments to supervise, in your case, mutual funds, but in the case of others, investment advisors, broker-dealers, *et cetera*? And you can begin, Ms. Rominger.

Ms. ROMINGER. I will start by giving an example of where having additional information has been very helpful to us, and that is in the area of money market fund regulation and oversight. Money market funds, as I mentioned in my opening comments, have a structural fragility in that they are susceptible to runs, as we saw in September 2008. In the first round of money market fund reform early in 2010, there was a requirement for money market funds to disclose holdings information to the SEC on a monthly basis. We started receiving that information exactly a year ago, at the end of November 2010, and we now have monthly holdings for money market funds.

So this is, I think, an instance where having that data has provided us very important information with respect to the way these funds are structured and the implications of that with respect to systemic risk. It is a subject of much conversation amongst the

SEC and other regulators who are involved in systemic risk work. I think that is a very good example of where it has been put to good purpose.

As I look at our responsibilities and think about where our greatest needs are, I think it is with respect to experts, technical experts, market experts, experts in analyzing complex financial strategies. I think that the Chairman has identified that as an area of increasing focus and increasing resource need for the SEC and that is certainly true in the Investment Management Division.

Chairman REED. Mr. Cook, do you have comments from your perspective?

Mr. COOK. Yes, sir. In terms of access to data, as I indicated in my opening remarks, one of the key challenges we face in monitoring the securities markets, the listed equity markets in particular, is just the enormous volume of data that is there and the relatively significant gap between our access and the ability to analyze that data in an efficient way. So we are working on a number of initiatives to try to narrow that gap.

I would say part of it is a rulemaking process to make sure that there are the rules in place or a structure in place to get that data to the regulators. That would be, for example, the consolidated audit trail and the large trader reporting system, where we will have better access to data.

But the second piece of it is having the resources internally to be able to make something of that data. We are working closely with our colleagues in other divisions, for example, when it comes to the consolidated audit trail to make sure that what we are designing is going to be useful for the examination program, for the enforcement program, as well as our own market oversight program. But it requires both people and technology to ultimately realize the promise of some of these data enhancement initiatives.

Another key one that we are working on is in the swaps markets, and there, we have a proposed regime for the reporting of all swaps to data repositories. But that will present opportunities and challenges for us again in terms of having greater access to information, but now we need the people and the technology to be able to leverage that information and be more effective regulators.

Chairman REED. Mr. di Florio.

Mr. DI FLORIO. I would just add, Chairman Reed, that there has been a tremendous amount of improvement, I think, with the Division of Risk Strategy and Financial Innovation to really help the SEC think about taking in significant amounts of data and doing more sophisticated analytics around that data. That has been very helpful, for instance, with us on the examination program to make sure that we are agile and we are not planning our exams based on old data, but taking in new data, doing analytics, and as we learn about trends or risks, being agile and directing our efforts there.

It has also been helpful to work with the Division of Investment Management and the Division of Trading and Markets to identify the data that we might be able to gather through the exam program, because we are in the field every day, and we have, I think, strengthened our ability and our coordination to be able to have dialogs with the firms around specific data that we think we need, for instance, exposure to Europe, so that we can not only get data in a raw form, but then have the critical dialogs that we need to have with the firms to have it make sense and have us be able to have a significant response to that data.

Chairman REED. Mr. Lewis or Ms. Cross.

Ms. CROSS. I would note in the Division of Corporation Finance, what we have focused our resources on recently in the review program is looking at the largest companies on a real time basis. So historically, we would have picked them up once a year, looked at their filing, given them some comments, and perhaps moved on after they responded. What we have figured out is that if we have our accountants and lawyers looking at most of what they say and do over the course of the year, we are able to pick up trends and improve the disclosures across whole areas of the industry based on what we are seeing with the leading companies, and I think this has been a great innovation in the Division and we hope to do more of it because I think that is much more valuable than the episodic picking up of a company, looking at its filing, and giving some comments.

Chairman REED. All right. Mr. Lewis, your comments, and then Mr. Khuzami.

Mr. LEWIS. Yes, if I could just give an example——

Chairman REED. Yes, sir.

Mr. LEWIS. ——of some of the cooperation and collaboration we have had with Carlo's Office, and what we have done is we have taken the data initiative in my Division, and the idea is to build risk assessment tools that can be used to essentially score investment management companies as to certain classes of risk. And so we are taking a layered approach; we begin by discussing what the needs are in the Office, and determine the key risks. We start with fairly simple models that just perform basic screening of filers. And the idea is, as we learn more about the risks in the space, we develop increasingly sophisticated analytic models. So we move from screening techniques to, let us say, regression-based techniques, in that order.

Chairman REED. Thank you.

Mr. Khuzami, any comments?

Mr. KHUZAMI. From the enforcement perspective, it is slightly different, but the same theme. We do everything that we can to get access to data and to analyze it, but we are seriously behind the curve in our ability to do that. I mean, if you want to conduct a thorough and proper insider trading investigation and make sure you get all the parties who may be involved in an illicit scheme, you would love to have ready access to all equity trading data and derivatives data and debt data and overlay a chronology of market-moving events and you would be able to see patterns and trends. We are trying to do some of that, but it is difficult. We need better tools, not only in analytics, but to be able to upload information and manipulate data to investigate it. It can take weeks and even months to upload the massive amount of electronic information we get in our investigation and we do not have the proper tools in order to be able to analyze it the way we would like to.

Chairman REED. I have two final questions, but Senator Merkley, do you have additional questions? Let me recognize you now and take your time and then I will conclude, I hope quickly.

Senator MERKLEY [presiding]. OK. Thank you, Mr. Chair.

I wanted to continue this conversation about information, but really focus on derivatives. Certainly, we did not have a very good understanding of the writing of derivatives here in the United States, and I am not sure that we have a very good understanding of it currently abroad. Conversations with some of the experts from our own rating companies have generated kind of a response of, no, we do not really understand who is writing, who is holding, how the dominos are set up regarding Europe. And, of course, a lot of credit default swaps are being written on a host of European firms and sovereign debt.

So I wanted to start—I realize that this is a world where the credit default—the swap world is so divided with interest and foreign exchange swaps on the CFTC side, equity swaps on the SEC side, so you all have a piece of this picture, but what do we know about European credit default swaps? And if we do not know enough, what needs to change?

Mr. COOK. Senator, maybe I could start with that and then invite Mr. Lewis to comment. The primary entities that we regulate that would be likely to take on direct exposures to this, are the broker-dealers, and anecdotally and through FINRA, our impression is it is not significant exposure to credit defaults. Also capital rules make it expensive to book a credit default swap in a broker-dealer.

However, obviously those transactions can be booked at other entities that are also of general regulatory interest with the banks or holding companies or financial institutions, and other regulators may have access to some of that information as well.

But I think overall, there is a gap in our knowledge of this, and I think the solution that we are working on, and the CFTC is as well, is the development of a mandatory trade reporting regime pursuant to Title VII of the Dodd-Frank Act, which would require all swap transactions to be reported to a data repository. That would be available to regulators.

There is a separate piece about reporting out to the marketplace, which is sort of a transparency piece. But in terms of our prudential systemic oversight of the markets and the risks——

Senator MERKLEY. Let me hold you on for just a second there. On that repository, when do we expect to have it up and operating?

Mr. COOK. Well, we have our proposed rules out for the data repository and we would, as I mentioned earlier, need to finish our proposal phase for Title VII and then begin adopting. So I think we would likely see adoption of this rule sometime in 2012, but I am not exactly sure. The order in which we adopt these rules is one of the things on which we want to get public comment.

I will say, though, that most parties we have spoken to have suggested that this ought to be one of the first things that we do because it will enhance our information that we have as regulators about what is out there, and may help inform our rulemaking in other areas of Title VII.

Senator MERKLEY. And I will say, in the context of what is going on in Europe, it seems like a critical element and it seems like one of the simpler elements that ought to be able to be put into place. Is there any parallel effort on the European or Asian side?

Mr. COOK. There are efforts to develop data repositories in other jurisdictions, yes. And to some extent, some of this information is available today through the trade warehouse that is operated in the U.S. Mr. Lewis's group has done some work in analyzing some of that data. It is not complete, and I think that what we are trying to get to is a complete picture.

Mr. LEWIS. So let me briefly tell you, Senator, about some of the work that my division has done on the credit default swap data that has been provided by the data warehouse. One of the projects that we have worked on is to characterize the positions and exposures of the participants in the swap market. And one of the, I think, take-aways that we have going up through the data through June of 2011 is that financial institutions have been unwinding their exposures to the PIIGS' debt, to basically sovereign European debt.

One of the issues, I think, that is critical if we want to consider and evaluate systemic risk is that we need to have a complete picture of all the parties that transact in this space. And to give you an example of why I think this is important, one of the experiments we conducted in our group to see how important this issue might be is we looked at positions by only considering U.S. financial institutions and U.S. counterparties, but excluded U.S. branches in foreign domiciles.

So take an investment bank, New York Investment Bank, consider their U.K. branches, ignore those U.K. branches transactions, and you get a picture of what the counterparty exposures are, what the positions look like across counterparties, gross exposures and net.

And then run the experiment again including all the exposures by also including the trades that occur in the international or the foreign branches, and what we discovered was that positions or exposures could reverse. So if you look like you were a purchaser of protection in a credit default swap market, when you incorporated all the branches, all the transactions we had access to, you could actually see the positions reversing.

If we are going to manage systemic risk, I would advocate we need to get all the trades, not just the trades that take place by U.S. banks and their branches, but if you want to measure systemic risk, you want to look at everybody who is in this market so you can get a complete picture of what the credit risk is like.

Senator MERKLEY. How does the Office of Financial Research fit into this issue of understanding the collective picture?

Mr. LEWIS. I have actually had discussions with the Office of Financial Research and alerted them to this issue, and I believe that they are actually working on it. Probably should not attribute workload to the Office of Financial Research, but it is certainly a suggestion that I have made to them, that they should investigate.

Senator MERKLEY. Thank you.

Chairman REED. Thank you, Senator Merkley, and let me just say that they would even be more responsive if they had a confirmed head of the Office of Financial Research. That is a message to the broader public.

Final question and I think it is an important one to ask and it is just really two parts. One is that there has been criticism lodged against the SEC about being too close to the institutions and the businesses that you regulate. Related to that is the issue of a revolving door process. And I wanted to get, Mr. di Florio, a comment on how you sort of deal with that in terms of making sure that does not affect your ability to effectively perform your duties on behalf of the public.

And then a related question. I ask this with trepidation because one of my former experiences was commanding a paratrooper company. If anybody asked my company how the morale was, I shuddered a little bit in terms of what they might say. But you might also indicate just what you sense the morale is in your division. Those are those two little related issues.

Mr. DI FLORIO. Sure. First, Senator Reed, we are very cognizant of the revolving door issues and have put in place a number of significant controls that really focus on that issue. We have an Ethics office that reports directly to the Chairman and has a new head and is very focused on ensuring that there are effective policies and procedures, and there are limitations on how people can interact with the SEC once they leave the SEC. They maintain that dialog with the Office of Ethics. So there are a lot of rules, both civil and criminal, that govern our conduct with regard to the revolving door.

In the Exam Program, in addition to that, we have our own Code of Conduct that adds additional requirements because we want to make sure that examiners do not present conflict of interest, and there are additional controls that require supervisors to be dialoguing with individuals on their team involved in various exams and make sure that there are not any conflicts or relationships.

I would make an observation on the flip side, which is that we have been able to bring in some terrific talent to the SEC that makes us relevant and current with regard to complex structured products, derivatives, hedge funds, because we are able to recruit people who have their finger on the pulse of industry practices.

And my observation in my own view has been that individuals that we have brought in with industry expertise and experience have been some of our most effective and aggressive examiners because they understand the games that registrants can play. They are very focused on targeting our efforts exactly to those high-risk points of interaction or product and making sure that we are identifying those issues.

So I think when it works well, the complement of our talented and dedicated existing team at the SEC, coupled with incoming individuals from industry to bring new expertise and experience, really strikes a terrific balance and makes us more effective in protecting investors, ensuring market integrity, staying in front of issues, and being able to protect the markets and investors.

With regard to the second issue on morale, I think that is a terrific question and something that we are very focused on at the SEC. Chairman Schapiro has fostered a very open culture of teamwork and collaboration, and I think that is stronger than it has probably ever been at the SEC.

At the same time, we have an incredible workload with Dodd-Frank and have made requests for more resources to help us meet that workload. And I think that tension can create some morale challenges that we need to be very cognizant of. There is a relationship between resources and morale and an ability to do the job well.

At the same time, we have initiated, throughout the agency, human capital surveys to make sure that we are keeping our finger on the pulse of morale, what are the root causes of morale concerns or issues, and putting in place action plans every year that are monitored to follow up on the morale issues.

And I think that that is something that we all need to make a priority and we do, as directors of the various divisions and offices. I know in the National Exam Program, people, culture, and morale is one of our top priorities this year.

Chairman REED. Thank you. Mr. Lewis, please, any comments?

Mr. LEWIS. With respect to the issue of morale?

Chairman REED. Or people coming in and out, too close. You are somewhat removed because of your analytical responsibilities, but those two topics, comments that you might have.

Mr. LEWIS. Well, if I had to comment on the revolving door, I would say it is probably a good thing for economists because they basically go back to their academic institutions when they revolve back out. And actually, if we can engage financial economists in becoming interested in regulation, it creates a lot more opportunity to see research being conducted, independent research being conducted around the rulemaking space. So you could argue it is a positive for my division.

With respect to morale, I have only been in the office since June, but I would like to think that things are going pretty well.

Chairman REED. Good. Ms. Rominger.

Ms. ROMINGER. In the Division of Investment Management, there are very few people in the division, with the exception of myself, who have come from the asset management industry. Frankly, I think we need additional people from the industry. It has grown much more complex over time.

Some of the challenges we are facing today are quite different than the challenges that the division faced 5 or 10 years ago, and with the increase in complexity, we need people on board who understand how these instruments and how these strategies actually work in the real world.

And so, we absolutely must have the correct protections in place to make sure that we have the appropriate distance as regulators, but we do need that expertise. So with respect to morale, in my 9 months at the SEC, I have found that most of the people I work with are motivated to engage in public service because of their strong desire that they can make things better and that is what drives them and motivates them.

And I think morale is quite good because I think they get a sense that there is a great deal of positive change occurring in the agency right now.

Chairman REED. Thank you. Mr. Cook, please.

Mr. COOK. Thank you. I think keeping in touch with the markets and keeping up to speed with the latest developments is critical to the effective implementation of our responsibilities and we do that through a variety of ways including the comment process, and meetings with market participants.

But the ability to bring in folks who have been on the other side and know where the issues lurk, I think, is pretty crucial. I echo the comments of my colleagues about how it is obviously crucial to manage the ethical obligations associated with that, but I think that that can be done and done effectively, and I think it has really enhanced and enriched our ability to try to get the rules right.

In terms of morale, I would just add that I am, having come from outside of Government into Government, I am truly amazed by the dedication of the staff and the long hours they put in on the tasks that we give them. The productivity in our division is many multiples of what it has been in some prior years in terms of just the output. Same number of people, much more being asked of them and it is truly remarkable how far they are willing to go.

I think to some extent, this is why they are there. This is a great time to be working at the agency and working on these key issues. But I would echo the concerns that have been mentioned already about how ultimately people do need to feel they have the resources to do their jobs effectively, and it is hard to take the hill if you do not have the right equipment and manpower.

Chairman REED. Absolutely. Ms. Cross.

Ms. CROSS. I agree with everything that has been said about the revolving door—the fresh insights that come in from people who have recently been in industry help us do our job better. And we are extremely careful about the ethical concerns. You have heard me mention recusals today. There is no shame in saying, I cannot work on something because I had a contact with it in my prior job, and I think that regularly occurs and I think that is an important——

Chairman REED. If I may, one of the concerns is not so much people coming in, it is the people going out, and——

Ms. CROSS. And I think on the going out front, I would say, since I have done that——

Chairman REED. Right.

Ms. CROSS. ——I think that overall, the investing public benefits because people who have worked at the Commission have an appreciation of what it is that we are trying to do, and I think SEC alumni are especially careful practitioners. I think they go out and populate the securities bar with people who want to do the right thing. So I think actually it is a very positive development and I would hope it will continue.

On the morale point, I would like to echo what Robert said about the incredibly hard work the staff is currently going through. I worry sometimes that we do not say enough about how much we appreciate them. You have to stop and take a deep breath and remember to do that a lot because they have all been sacrificing their personal lives to work through the Dodd-Frank rulemaking, and before that we were very busy in my division with rulemaking. So it has been flat-out for 2½ years since I have been there.

And then on the review program, I am amazed every day at how enthusiastic and fresh they remain when they pick up a company and they look at the filing and they search the Internet to see what else the company is saying and come up with good comments that improve the disclosures.

And I think that—I hope—morale is good. It is hard to know with as many people as we have, but I would say that I know I appreciate how hard they are working.

Chairman REED. Thank you. Mr. Khuzami.

Mr. KHUZAMI. Yes, thank you, Mr. Chairman. I agree with the sentiments expressed here. With respect to the expertise, it is critically important. You know, it was not very long ago at all that everyone was criticizing the SEC for lacking the expertise in order to deal with complex products and transactions and markets, and we have done that.

We have as good, if not better, set of ethical restrictions on the way out with respect to permanent bans on involvement in matters that you participated in once you leave, 2-year ban on being involved in matters that you supervised, and just down the line a great deal of restrictions.

Second of all, in my experience, both in the Department of Justice and here, particularly the SEC, the ability of one person, even if they were so inclined, not to do anything other than follow a case on its merits and make a recommendation and decision and take investigative steps that were in the best interest of the case, is virtually impossible to do.

We work in teams with great levels of review by multiple people, with thorough oversight. It would be very difficult for one person to do that, even if they were so inclined, and I have not met such a person.

In addition, that is not the way you would gain any respect within the Enforcement Division and within the Commission. You are respected if you are hard-driving and thorough and professional and disciplined and intelligent. And to do anything else hurts your reputation, hurts your ability in the outside world, when and if you were to leave.

And last, the people who leave the SEC are really Ambassadors for compliance and good practices. They go to firms and they advise clients and they know the consequences of what can happen if they cross the line, and we have to leverage those people so that some CEO who may be inclined to take a shortcut will listen to their general counsel or their compliance officer who says, Here is what can happen to you, here is what the SEC might do if you do not act appropriately. So I think it is a win-win all the way around.

GAO looked at our revolving door issues as part of Dodd-Frank and came away with the single recommendation that we should better document our ethics advice. And so, I think all in all, the arrangement is the right one for investors.

With respect to morale, people work incredibly hard and are incredibly committed. The undifferentiated criticism that sometimes occurs takes its toll, quite honestly. People are not afraid of being told that they can do things better. We restructured the entire Enforcement Division. People responded in a way that is in the best traditions of anybody in the public or private sector. You know, do not shoot the messenger. Look at what is the right thing to do. Make changes that are necessary. That has occurred up and down throughout the division.

What will happen is eventually if the market turns and people do not have the resources they need, they will be more attracted to jobs on the outside and that would be a terrible, I think, result for investor protection and our efforts because our employees are highly valued and experienced.

They want to be at the SEC. They want to be public servants. It can be difficult if you are at the Xerox machine at 11 o'clock at night photocopying your own trial exhibits. That is what happens.

Chairman REED. Well, thank you all very, very much today, not only for your thoughtful responses and testimony, but for your dedicated public service and particularly your patience. Thank you all.

If Members, my colleagues, have their own written statements or additional questions for witnesses, they should be submitted no later than next Wednesday, November 23rd, and I would ask the panel to respond as quickly as possible to any written questions you may receive.

All the written testimony that you have submitted will become part of the record. Again, I thank you for your service and for your testimony this morning. With that, the hearing is adjourned.

[Whereupon, at 11:31 a.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED JOINT STATEMENT OF HEARING WITNESSES FROM THE SECURITIES AND EXCHANGE COMMISSION

NOVEMBER 16, 2011

Testimony on "Management and Structural Reforms at the SEC: A Progress Report"

By

Robert Khuzami, Director, Division of Enforcement
Meredith Cross, Director, Division of Corporation Finance
Robert Cook, Director, Division of Trading and Markets
Carlo di Florio, Director, Office of Compliance Inspections and Examinations
Eileen Rominger, Director, Division of Investment Management
Craig Lewis, Chief Economist and Director, Division of Risk, Strategy, and Financial Innovation
U.S. Securities and Exchange Commission

Before the
United States Senate Committee on Banking, Housing and Urban Affairs
Subcommittee on Securities, Insurance, and Investment

Wednesday, November 16, 2011

Chairman Reed, Ranking Member Crapo, Members of the Subcommittee:

Thank you for the opportunity to testify today on behalf of the U.S. Securities and Exchange Commission.

As Directors of six major divisions and offices of the SEC, each of us came to the agency within the past three years dedicated to furthering the Commission's vital mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation. We appreciate the opportunity to discuss the broad responsibilities performed by the SEC, the recent reforms we have undertaken, and the challenges that lie ahead.

Our testimony today will discuss a number of significant steps that we have taken over the past few years in our divisions and offices to reform and improve our operations. As part of that effort, we have revitalized and restructured our enforcement and examination functions, revamped our handling of tips and complaints, taken steps to break down internal silos and create a culture of collaboration, improved our risk assessment capabilities, recruited more staff with specialized expertise and experience, and enhanced safeguards for investors' assets.

Despite these changes, much work remains, and we continue to seek ways to improve our operations and make the SEC more vigilant, agile, and responsive.

Current Challenges

FY 2012 will be a critical period for the SEC. Not only does the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") create significant additional mandates for the SEC, both in the short and long term, but the agency must continue to carry out its longstanding core responsibilities. These responsibilities — pursuing securities fraud, reviewing public company disclosures and financial statements, inspecting the activities of investment advisers, investment companies, broker-dealers and other registered entities, and maintaining fair and efficient markets — remain essential ingredients to restoring investor confidence and trust in financial institutions and markets following the recent financial crisis.

Over the past decade, the SEC has faced significant challenges in maintaining a staffing level and budget sufficient to carry out its core mission. The SEC experienced three years of frozen or reduced budgets from FY 2005 to 2007 that forced a reduction of 10 percent of the agency's staff. Similarly, after significant increases in technology spending from FY 2002 to FY 2005 the agency's investments in new or enhanced IT systems declined about 50 percent from FY 2005 to 2009.

As a result of increased funding levels in FY 2009 and FY 2010, current SEC staffing levels are just returning to the level of FY 2005, despite the enormous growth in the size and complexity of the securities markets since then. During the past decade, for example, trading volume has more than doubled, the number of investment advisers has grown by 50 percent, and the assets they manage have increased to $43 trillion. A number of financial firms spend many times more each year on their technology budgets alone than the SEC spends on all of its operations. Six years ago, the level of SEC funding was sufficient to provide 19 examiners for each trillion dollars in assets under management by investment advisers. Today, that figure stands at 12 examiners per trillion dollars.

Today, the SEC has responsibility for approximately 35,000 entities, including oversight of 11,700 investment advisers, 9,500 mutual funds and ETFs and close to 5,000 broker-dealers with more than 160,000 branch offices. We also review the disclosures and financial statements of nearly 10,000 reporting companies. The SEC also oversees approximately 500 transfer agents, 15 national securities exchanges, 8 active clearing agencies, and several nationally recognized statistical ratings organizations (NRSROs), as well as the Public Company Accounting Oversight Board (PCAOB), Financial Industry Regulatory Authority (FINRA), Municipal Securities Rulemaking Board (MSRB), and the Securities Investor Protection Corporation (SIPC). In addition, the Enforcement Division has jurisdiction over any person or entity that violates the securities laws, regardless of whether they are associated with one of these 35,000 entities.

In addition to our traditional market oversight and investor protection responsibilities, the enactment of the Dodd-Frank Act has added significant new responsibilities to the SEC's workload. These new responsibilities include a parallel set of responsibilities to oversee the over-the-counter derivatives market, including direct regulation of participants such as security-based swaps dealers, venues such as security-based swap execution facilities, warehouses such as security-based swap data repositories, and clearing agencies set up as long-term central counterparties. In a similar fashion, whereas the agency has long overseen traditional asset managers, under the Dodd-Frank Act, the SEC has been charged with similar responsibilities for private fund advisers, including those that trade with highly complex instruments and strategies. Additionally, the Commission has new responsibility for the registration of municipal advisors, enhanced supervision of NRSROs, heightened regulation of asset-backed securities, and creation of a new whistleblower program.

In acknowledgement of this significant new workload, the Dodd-Frank Act authorized a significant increase in the agency's budget authority over the next several years. So far, the SEC has proceeded with the first stages of implementation of the Dodd-Frank Act without additional funding as appropriations have not matched the increased budget authority. This implementation activity largely has involved performing studies, analyses, and writing rules. These initial tasks have taken staff time away from other critical responsibilities, as we have carried them out almost entirely with existing staff. It is the next step of making the new oversight regimes operational that will require significant additional resources.

This resource gap was highlighted in a report prepared by the Boston Consulting Group (BCG) pursuant to Section 967 of the Dodd-Frank Act that directed the agency to engage the services of an independent consultant to study a number of specific areas of SEC operations. In addition to highlighting this resource gap, the BCG study is providing an opportunity to re-examine and improve the SEC's operations. The Commission staff is conducting a thorough analysis of each recommendation and designing appropriate approaches for those recommendations selected for implementation.

Notwithstanding these challenges, the Commission remains committed to serving the public in satisfying our three-part mission. To this end, it is incumbent upon us to use our existing resources as efficiently as we can. Simply put, as we protect investors, we have an obligation to be good stewards of the resources that are or may be allotted to us.

DIVISION OF ENFORCEMENT

Director, Robert Khuzami[1]

A vigorous enforcement program is at the heart of the agency's efforts to protect investors and promote the integrity of the marketplace. As the SEC's largest division, the Enforcement Division investigates and brings civil charges in federal district court or in administrative proceedings based on violations of the federal securities laws. Successful enforcement actions result in sanctions that deter wrongdoing, protect investors, both now and in the future, and result in penalties and the disgorgement of ill-gotten gains that are returned to harmed investors, as well as barring wrongdoers from working in the industry.

Structural Reforms

Over the past two years, the Enforcement Division carried out the most significant structural reforms of the enforcement program since 1972 — reforms designed to maximize resources and enable us to more effectively combat securities fraud. Highlights of this programmatic transformation include:

Specialization. The introduction of five new national specialized investigative units dedicated to high-priority areas of enforcement which consist of: Asset Management (hedge

[1] Mr. Khuzami joined the SEC as Director of Enforcement in March 2009. http://www.sec.gov/news/press/2009/2009-31.htm

funds and investment advisers), Market Abuse (high-volume and computer-driven trading strategies, large-scale insider trading, and market manipulation schemes), Structured and New Products (various derivative products), Foreign Corrupt Practices Act violations, and Municipal Securities and Public Pensions. The specialized units, as well as various specialization initiatives in our regional offices, are utilizing enhanced training, specialized industry experience and skills, and targeted investigative approaches to better detect links and patterns suggesting wrongdoing — and ultimately to conduct more efficient and effective investigations. In addition to investigative work, the specialized units are engaged in a number of initiatives with our colleagues in the Office of Compliance Inspections and Examinations (OCIE) and other divisions to develop risk analytics that proactively identify high-risk areas for further examination and investigation.

Management Restructuring. The Division has adopted a flatter, more streamlined organizational structure under which it has reallocated a number of managerial staff to the mission-critical work of conducting front-line investigations. While a layer of management has been eliminated, the Division is maintaining staff-to-manager ratios that allow for close substantive consultation and collaboration, resulting in a management structure that facilitates timeliness, quality, and staff development.

Office of the Managing Executive. A strong operations function is also critical to the success of the Division. To that end, we created the Office of the Managing Executive to apply critical expertise to the operations arena. This office now oversees functions such as IT forensics and litigation support, case management systems, and collections and distributions activities; and broader operational areas like the budget, process improvement and project management, internal controls, and human resources. This office is also leading the division's efforts to create and collect data, including a set of quantitative and qualitative metrics, and to incorporate this data into our regular case review process. The result of creating this "COO-type" function within the Division is that the critical operational tasks just mentioned will be performed by persons with the appropriate expertise, thus leaving more time for the staff to focus on the mission-critical work of conducting investigations and core enforcement activities.

Office of Market Intelligence. Enforcement established an Office of Market Intelligence to serve as a central office to handle tips, complaints and referrals ("TCRs") that come to the attention of the division; coordinate Enforcement's risk assessment activities; and support Enforcement's strategic planning activities. This office will allow the division to have a unified, coherent, coordinated response to the huge volume of TCRs we receive every year, thereby enhancing our ability to conduct the right investigations, bring solid cases, and effectively protect investors. In addition, we will use this information to identify emerging threats to investors and markets, which will in turn inform how we employ our limited enforcement resources in order to optimize investor protection and deterrence.

Moreover, over the past two years, we have completely revamped the way the entire agency handles TCRs, including new policies, procedures and systems, as well as creating a centralized database so that staff across the agency has this information available to them. The TCR system improves our ability to obtain information from the public while providing the staff with workflow tools to better correlate, prioritize, assign and track progress of TCRs through to resolution.

Streamlining Process. We improved our law enforcement capabilities and sent a clear signal internally and externally that we value toughness and speed. For example, the Commission delegated to senior staff the authority to initiate formal investigations and issue subpoenas without the prior approval of the Commission. We also have eliminated approvals for certain routine settlement discussions, Wells notices and the opening of initial matters under investigation. Proper levels of supervision and oversight remain across all of these areas.

Whistleblower Office. The Dodd-Frank Act substantially expands the agency's authority to compensate individuals who provide the SEC with useful information about violations of the federal securities laws. Last November, the Commission proposed rules mapping out the procedure for would-be whistleblowers to provide critical information to the agency. The Commission adopted final rules in May, which became effective on August 12, 2011. The final rules set forth how eligible whistleblowers must submit their tips to be eligible for an award, the process to apply for an award, and sets forth eligibility criteria and applicable definitions. The Office of the Whistleblower is currently staffed with six attorneys and a senior paralegal and is actively recruiting a Deputy Chief. Staff in the Office of the Whistleblower are communicating with whistleblowers and their counsel, conducting internal and external training sessions and working with enforcement staff on documenting whistleblowers' ongoing contributions to current investigations. The Commission also has fully funded from monetary sanctions collected in enforcement actions, the SEC Investor Protection Fund, which will be used to pay awards to qualifying whistleblowers.

Cooperation Program. We have added a series of measures to encourage corporate insiders and others to come forward with evidence of wrongdoing. These new cooperation initiatives establish incentives for individuals and companies to fully and truthfully cooperate and assist with SEC investigations and enforcement actions. This program encourages "insiders" with knowledge of wrongdoing to come forward early, thus allowing us to build stronger cases and shut down fraudulent schemes earlier than would otherwise be possible.

Effective Results

Record Number of Enforcement Actions Filed. Although statistics alone cannot capture the breadth of the Division's work, since undertaking these reforms, the SEC's enforcement activity has increased significantly, resulting in substantial benefits for markets and investors. In recently-ended fiscal year 2011, the first complete fiscal year since the Division's reorganization, the SEC filed 735 enforcement actions – more enforcement actions than ever filed in a single year in SEC history. Those enforcement actions resulted in more than $2.8 billion in penalties and disgorgement ordered in fiscal year 2011. In fact, in each of the past three fiscal years, we have filed more enforcement actions than in the previous fiscal year.

Financial Crisis Cases. During the last two-and-a-half years, the agency has filed 36 separate actions in its financial crisis-related cases against 81 defendants – nearly half of whom were CEOs, CFOs and senior corporate executives, resulting in approximately $1.97 billion in disgorgement, penalties, and other monetary relief obtained. This includes enforcement actions against Goldman Sachs and Citigroup, as well as senior executives from Countrywide Financial, New Century and American Home Mortgage. In FY 2011, the SEC filed 15 separate financial-crisis-related actions naming 17 individuals, including 16 CEOs, CFOs and other senior corporate officers, involving wrongdoing related to the financial crisis. These cases include enforcement actions involving collateralized debt obligations (CDOs) charging J.P. Morgan with misleading investors in a CDO as the housing market began to plummet, Wachovia Capital Markets with misconduct in the sale of two CDOs tied to the performance of residential mortgage-backed securities, and two firms (Stifel, Nicolaus & Co. and RBC Capital Markets) with misconduct in the sale of unsuitable CDO investments to five Wisconsin school districts. The SEC also charged six executives at Brooke Corporation and three executives at mortgage lender IndyMac Bancorp for misleading investors about the deteriorating financial condition at their respective companies. Separately, Morgan Keegan & Company this year paid $200 million to settle charges brought in fiscal year 2010 that it falsely valued subprime mortgage securities in five funds managed by an affiliate, with the controller and portfolio manager also charged.

Insider Trading Cases. The Division's focus on insider trading cases has resulted in enhanced enforcement, with 57 actions filed in fiscal year 2011 by the SEC – a nearly 8 percent increase over last year's total. Among those charged in SEC insider trading cases in the past fiscal year were various hedge funds managers and traders involved in a $30 million expert networking trading scheme, a former NASDAQ Managing Director, a former Major League Baseball player and an FDA chemist. The SEC also brought insider trading charges against a Goldman Sachs employee and his father who traded on confidential information learned at work on the firm's ETF desk, and a corporate board member of a major energy company and his son for trading on confidential information about the impending takeover of the company. In fiscal year 2011, the SEC obtained judgments in 18 actions arising out of its investigation of hedge fund manager Raj Rajaratnam, the founder of Galleon Management, who was recently convicted of multiple counts of insider trading. Just last week, the SEC obtained a record financial penalty of $92.8 million in its civil action against Rajaratnam. In addition, the SEC provided significant assistance to the U.S. Attorney's Office for the Southern District of New York in its successful criminal prosecution of Rajaratnam.

Financial Fraud and Issuer Disclosure Cases. The SEC brought 89 actions in fiscal year 2011 charging financial fraud and issuer disclosure violations. Those cases included actions charging Satyam Computer Services Limited with fraudulently overstating its financial results by more than $1 billion over five years, the India-based affiliates of PricewaterhouseCoopers for their audit failures related to Satyam, and DHB Industries, Inc., a major supplier of body armor to the U.S. military and law enforcement agencies, for engaging in a massive accounting fraud. The SEC also filed separate fraud charges against DHB's former outside directors and audit committee members charging them with facilitating the company's fraud.

Investment Adviser and Broker-Dealer Cases. The agency filed a total of 146 enforcement actions related to investment advisers and investment companies, a single-year record and 30 percent increase over fiscal year 2010. The SEC also brought 112 enforcement actions related to broker-dealers in fiscal year 2011, a 60 percent increase over last fiscal year. Among those charged in SEC investment adviser and broker dealer actions in the past fiscal year were Charles Schwab entities and executives for making misleading statements to investors regarding a mutual fund heavily invested in mortgage-backed and other risky securities, AXA Rosenberg Group LLC and its founder for concealing a significant error in the computer code of the quantitative investment model that they used to manage client assets, and Merrill Lynch, Pierce, Fenner & Smith for misusing customer order information to place proprietary trades for the firm and for charging customers undisclosed trading fees. The Schwab entities paid more than $118 million to settle the SEC's charges, while AXA Rosenberg paid $217 million to cover investor losses and a $25 million penalty.

Cases Arising from Cross Border Working Group. The work of the SEC's Cross Border Working Group, a proactive risk-based initiative focusing on U.S. companies with substantial foreign operations, led to numerous important enforcement actions in fiscal year 2011. This included the first-ever stop orders for post-effective registration statements due to the resignation of a company's independent auditor and multiple trading suspensions of China-based U.S. securities because of concerns over the accuracy and completeness of their publicly filed information.

Cases Targeting Vulnerable Investors. The SEC also brought actions against individuals and firms charging them with targeting vulnerable investors in fiscal year 2011, such as cases charging the three senior executives at Fair Finance Company with orchestrating a $230 million fraudulent scheme involving thousands of investors, many of them elderly, and the internet-based investment company Imperia Invest IBC with operating a scheme targeting many members of the deaf community.

Finally, the following sample of cases filed by the Enforcement Division in one seven-day period in October 2011 reveals both the complexity and the diversity of the markets, practices, and products that we police, as well as the depth of expertise needed to do our job effectively:

- Failure to disclose to investors that a firm structuring and marketing a $1 billion collateralized debt obligation also exercised significant influence over the selection of $500 million of the assets included in the CDO and took a proprietary short position concerning those $500 million of assets during a time when the U.S. housing market was showing signs of distress. (*SEC v. Citigroup Global Markets and Brian H. Stoker*, filed October 19, 2011);
- Misleading representations to customers of a "dark pool" trading platform that customers' interests in trading large amounts of stock would be anonymously matched while failing to disclose that the overwhelming majority of the shares traded on its dark pool platform were in fact bought or sold by a wholly owned subsidiary of Pipeline. (*SEC v. Pipeline Trading System LLC, Fred Federspeil and Alfred R. Berkeley III*, filed October 24, 2011);
- Insider trading by a then-director of both Goldman Sachs and Procter & Gamble who provided confidential Board information about both companies' quarterly earnings and about an impending $5 billion Berkshire Hathway investment in Goldman Sachs to Raj Rajaratnam, the now-convicted founder of the Galleon hedge fund, who traded on that information. (*SEC v. Rajat K. Gupta and Raj Rajaratnam*, filed October 26, 2011); and
- Misleading statements to prospective investors by an investment advisory firm and its principal concerning the principal's education, work experience, and the fund's auditor,

prime broker/custodian, and corporate status when soliciting individuals to invest in their purported quantitative hedge fund while at the same time diverting investor money to the principal's personal bank account. (*SEC v. Locust Offshore Management and Andrey C. Hicks*, temporary restraining order and asset freeze filed October 26, 2011).

Upcoming Challenges

Two overarching principles drive the Division's enforcement program. First, we need to stop fraud and misconduct as early as possible, before investor losses have mounted, evidence becomes stale, perpetrators have vanished, and the opportunities to partner with our criminal law enforcement colleagues to employ undercover and other proactive investigative techniques have been lost. Second, we must be an effective enforcement and deterrent force in complex markets and with regard to opaque and complicated products and transactions. This can be accomplished through increased expertise, recruitment and retention of high-quality legal talent, and expanded use of market data and other quantitative analytics. As shown above, the Division's record fiscal year 2011 achievements in both the quality and quantity of cases reflect that we are achieving both of these visions – an accomplishment all the more noteworthy given that it occurred side-by-side with implementation of the biggest restructuring in the history of the Division.

The Enforcement program continues to face challenges in securing the necessary expertise, human capital and technology resources to fulfill our mission of investor protection. For example, in the market abuse area, we need increased expertise and human capital to analyze new trading technologies, such as high-frequency and algorithmic trading, data feed latency issues, and large volume trading, as well as systemic insider trading and manipulation schemes. In the asset management area, we must keep pace with the ever-evolving issues of valuation of illiquid portfolios, false performance claims, preferential redemptions, and high-risk emerging products. In the municipal securities markets, we need better understanding of pension liability disclosures, valuation issues, and tax-arbitrage activities. These examples are just part of a broader array of challenges stemming from the fast-paced change and increasing complexity apparent in the financial products, markets, transactions, and practices that the Division confronts.

Integral to our understanding of these and other areas is an improved ability to analyze large volumes of information, including both structured and unstructured data. As a result of subpoenas and other information-gathering efforts, the Division receives each month approximately three to four terabytes of electronic data. As a comparison, 20 terabytes is often noted as the equivalent to the printed book collection of the U.S. Library of Congress. We need enhanced tools to consolidate and mine this data, link it together, and combine it with data sources from within and beyond the Commission. This level of analysis would enable staff to more effectively identify risks to investors, trends in the markets, and patterns of activity that may merit further investigation.

CORPORATION FINANCE
Director, Meredith Cross[2]

The Division of Corporation Finance (CF) is responsible for overseeing the agency's review of company disclosure to the investing public. The Division has two primary missions: to see that investors have access to material information and to deter fraud and misrepresentation in the offering, trading, voting, and tendering of securities. The Division's primary authority is derived from three statutes: the Securities Act of 1933 ("1933 Act"), the Securities Exchange Act of 1934 ("1934 Act"), and the Sarbanes-Oxley Act of 2002.

Generally, CF reviews company filings, makes rulemaking recommendations to the Commission, and provides interpretive advice to market participants and the public about the securities laws and corresponding regulations. During FY 2011, the Division established three new offices – the Office of Structured Finance, which focuses on disclosure reviews and policy-making for asset-backed securities and other structured products; the Office of Capital Markets Trends, which evaluates trends in securities offerings and in our capital markets to determine whether our rules, regulations, and review approach are adequately addressing them; and a new review group in disclosure operations, which focuses on the largest financial institutions. In light of budget constraints, the Division staffed these offices almost entirely by transferring existing staff to them. If resources permit, the Division plans to add resources to these offices to fully staff them to enable them to carry out their intended work.

Review of Filings
CF selectively reviews filings of new issuers and public companies reporting under the 1934 Act to both monitor and enhance compliance with disclosure and accounting requirements. The particular filings reviewed are selected based on the Division's non-public selective review criteria. The staff members engaged in filing reviews have accounting and disclosure expertise aligned with the industries in their respective review groups. Approximately 80 percent of the staff of the Division is assigned to the disclosure review program.

The Sarbanes-Oxley Act requires the Commission to review disclosures made by companies reporting under the 1934 Act at least once every three years and more frequently where circumstances warrant. Under Sarbanes-Oxley, this review is required to include the company's financial statements. In fulfilling its missions, the staff reviews the disclosure of many companies more often than once every three years. For example, the largest companies that represent the most risk to investors are reviewed more often and the largest financial institutions currently are reviewed continuously on a real-time basis. CF also selectively reviews registration statements and other filings made under the 1933 Act and the 1934 Act relating to capital raising transactions or business combinations. For example, the staff in CF has also allocated its resources to the review of 1934 Act filings made in connection with reverse mergers.

In the course of a review, the staff will issue comments to a company to elicit better compliance with applicable disclosure requirements. In response to those comments, a company may need to amend its financial statements or other disclosures to provide additional or enhanced

[2] Ms. Cross joined the SEC as Director of Corporation Finance in June 2009.
http://www.sec.gov/news/press/2009/2009-78.htm

information, or may undertake to improve its disclosures in future filings. Where appropriate, CF refers matters to the Division of Enforcement.

CF is in the process of enhancing its disclosure review program, including by increasing its focus on large and financially significant registrants The increased focus on these companies requires greater resources than traditional disclosure reviews, and the ability to implement these enhancements turns on whether we are able to allocate sufficient resources, balancing all other demands on the Division and its limited staff.

Smaller reporting companies – generally, those with a public float less than $75 million – comprise over half of the public companies filing with the SEC, yet their aggregate market capitalization is less than one percent of the total market capitalization of all reporting companies that the Division reviews. While these companies, and investors making decisions about them, may particularly benefit from detailed SEC staff review, in light of resource constraints and the small market capitalization of these issuers, the Division is in the process of recalibrating its reviews of smaller companies to gain efficiencies, while still satisfying the Sarbanes-Oxley Act mandate to review the financial statements of all public companies at least once every three years.

Interpretive Advice

CF provides advice to market participants and the public through interpretive releases, staff legal and accounting bulletins, updates to the Division's financial reporting manual, no-action and interpretive letters, issuance of compliance and disclosure interpretations and staff disclosure guidance topics on the Commission's website, and responses to telephone and e-mail inquiries. As the Commission implements the remaining rules required under the Dodd Frank Act, CF expects there to be an increase in workload in requests for interpretive advice.

Rulewriting

CF also recommends new rules or changes to existing rules to the Commission as needed to improve investor protection through enhanced disclosure requirements and to facilitate capital formation. CF's recent rulewriting activities have focused on asset-backed securities, proxy disclosure and voting, and Dodd-Frank Act implementation. Most recently, CF has commenced a significant project designed to facilitate capital formation by reviewing and if consistent with investor protection, recommending changes to current offering rules. These efforts, which have been largely staffed using existing resources, are described briefly below.

Capital Formation Matters. The Division is currently reviewing some of the current offering rules to develop ideas for the Commission to consider that may reduce the regulatory burdens for capital formation, including for small business, in a manner consistent with investor protection. These include:

- **The number of shareholders and other triggers for public reporting.** The staff is reviewing the triggers for public reporting and the characteristics of companies that should be subject to public reporting obligations. To facilitate the Commission's review of the issues related to the thresholds for public reporting (and those for leaving the reporting system), the staff is undertaking a robust study much like the one conducted when Section 12(g) was enacted. The study is seeking to determine whether the current thresholds and standards effectively implement the 1934 Act registration and reporting requirements and what it means to be a "public" company such that an issuer should be required to register its securities and file with the Commission. The staff has begun a detailed analysis of public company information – including numbers of record and beneficial owners, total assets, and public float – to assess the characteristics of public companies. The study also will seek to obtain and consider private company information to assess current reporting thresholds.

- **The restriction on general solicitation in private offerings.** CF staff is also reviewing the restrictions the Commission's rules impose on communications in private offerings, in particular the restrictions on general solicitation. In analyzing whether to recommend changes to the restriction, the staff is considering next steps, and is preparing a concept release for the Commission's consideration, through which it could seek the public's input on the advisability and the costs and benefits of retaining or relaxing the restrictions on general solicitation.

- **Restrictions on communications in public offerings.** The Division's staff is also assessing the Commission's rules, and the regulatory burdens they impose, with respect to communications in public offerings. The staff is reviewing the rules to consider whether any of the liberalizations adopted in 2005[3] for the largest issuers should be adapted for smaller public companies, including whether more companies should be able to use free writing prospectuses before a substantially complete prospectus is filed. As a result of this review, Division staff may recommend proposed changes to the offering rules, or recommend that the Commission seek additional input through the issuance of a concept release.

Additional areas CF staff is reviewing with respect to capital formation concern the regulatory questions posed by new capital raising strategies, such as crowdfunding, and the scope of the Commission's existing rules that provide for capital raising, such as Regulation A.

In connection with these projects, the Division will consider recommendations of the recently-formed SEC Advisory Committee on Small and Emerging Companies and the Government Business Forum on Small Business Capital Formation, as well as ideas from other sources in developing recommendations for the Commission's consideration to facilitate small business capital formation, consistent with investor protection.

Improvements to proxy voting and shareholder communications processes. The Commission received significant public comment on its concept release regarding proxy voting and shareholder communications.[4] CF staff is working closely with other SEC divisions and offices with regard to possible recommendations to the Commission for proposed rule amendments or other Commission action to address areas that may be in need of improvement.

[3] *See* Release No. 33-8591, *Securities Offering Reform* (July 19, 2005), http://www.sec.gov/rules/final/33-8591.pdf.
[4] *See* Release No. 34-62495, *Concept Release on the U.S. Proxy System* (July 14, 2010), http://www.sec.gov/rules/concept/2010/34-62495.pdf.

Asset-backed securities. The Division is preparing recommendations for the Commission to consider adopting several ABS rules, following rule proposals in April 2010 and a reproposal in July 2011. In April 2010, the Commission proposed significant revisions to the disclosure, reporting and offering process for asset-backed securities.[5] In July 2011, the Commission re-proposed some of the proposals from April 2010, including the proposals relating to the shelf eligibility requirements for ABS, and requested comment on other aspects of the April 2010 proposal.[6] The comment period for the July 2011 release ended on October 4, 2011.

Dodd-Frank Rules. In addition to the rulemaking initiatives discussed above, CF staff is responsible for preparing recommendations for the Commission to adopt rules to implement a significant number of Dodd-Frank Act requirements. CF reassigned a number of attorneys from throughout the Division, including disclosure operations, to work on these rulemaking projects. CF completed several projects mandated by the Dodd-Frank Act during FY 2011, and expects to present the Commission with recommendations to complete the remaining rulemaking projects during FY 2012.

Dodd-Frank rules for which CF is responsible include, among others, the following:

Asset-Backed Securities. Asset-backed securities (ABS) rules in a number of areas, including, among others:

- **Representations and Warranties.** On January 20, 2011, the Commission adopted final rules to implement Section 943 of the Dodd-Frank Act, which requires the Commission to adopt rules regarding representations and warranties in ABS.[7]

- **Issuer Review of Underlying Assets.** On January 20, 2011, the Commission adopted final rules to implement Section 945 of the Dodd-Frank Act.[8] Section 945 requires the Commission to issue rules requiring an asset-backed issuer in a 1933 Act registered transaction to perform a review of the assets underlying the ABS, and disclose the nature of such review.

- **Risk Retention.** On March 30, 2011, the Commission joined fellow financial regulators in issuing for public comment proposed risk retention rules to implement Section 941 of

[5] *See* Release No. 33-9117, *Asset-Backed Securities* (April 7, 2010), http://www.sec.gov/rules/proposed/2010/33-9117.pdf.

[6] *See* Release No. 33-9244, *Re-proposal of Shelf Eligibility Conditions for Asset-Backed Securities and Other Additional Requests for Comment* (July 26, 2011), http://www.sec.gov/rules/proposed/2011/33-9244.pdf.

[7] *See* Release No. 33-9175, *Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (January 20, 2011), http://www.sec.gov/rules/final/2011/33-9175.pdf.

[8] *See* Release No. 33-9176, *Issuer Review of Assets in Offerings of Asset-Backed Securities* (January 20, 2011), http://www.sec.gov/rules/final/2011/33-9176.pdf.

the Dodd-Frank Act.[9] The proposed rules address the appropriate amount, form, and duration of required risk retention for ABS securitizers, and the definition of qualified residential mortgages. Although the original comment period was scheduled to close on June 10, 2011, in light of requests from various sources for an extension to allow sufficient time for data gathering and impact analyses related to the provisions of the proposed rule, the Commission extended the comment period to August 1, 2011. The Commission staff, together with staff from the other regulators, is carefully considering the issues and concerns raised in the comments received as it prepares recommendations for the Commission for final rules.

- In August 2011**,** the Commission adopted rules in connection with Section 942(a) of the Dodd-Frank Act, which eliminated the automatic suspension of the duty to file reports under Section 15(d) of the 1934 Act for ABS issuers and granted the Commission authority to issue rules providing for the suspension or termination of this duty to file reports. The new rules permit suspension of the reporting obligations for ABS issuers when there are no longer asset-backed securities of the class sold in a registered transaction held by non-affiliates of the depositor.[10]

Corporate Governance and Executive Compensation. Corporate governance and executive compensation provisions of the Dodd-Frank Act including, among others:

- **"Say-on-Pay" and "Golden Parachute."** In January 2011, the Commission adopted rules to implement the provisions of the Dodd-Frank Act that require public companies subject to the federal proxy rules to provide their shareholders with:
    - an advisory vote on executive compensation, generally known as "say-on-pay" votes, as well as with an advisory vote on the desired frequency of say-on-pay votes.
    - an advisory vote on compensation arrangements and understandings in connection with merger transactions, known as "golden parachute" arrangements.

- **Compensation Committees and Compensation Consultants**. The Commission is required by Section 952 of the Dodd-Frank Act to mandate new listing standards relating to the independence of compensation committees and to establish new disclosure requirements and conflict of interest standards that boards must observe when retaining compensation consultants. In March 2011, the Commission issued a proposal to implement Section 952.[11] The comment period for the proposal ended on May 19, 2011, and the staff is currently developing recommendations for final rules.

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[9] *See* Release No. 34-64148, *Credit Risk Retention* (March 30, 2011), http://www.sec.gov/rules/proposed/2011/34-64148.pdf.

[10] See Release No. 34-65148, *Suspension of the Duty to File Reports for Classes of Asset-Backed Securities under Section 15(d) of the Securities Exchange Act of 1934* (August 17, 2011), http://www.sec.gov/rules/final/2011/34-65148.pdf.

[11] *See* Release No. 33-9199, *Listing Standards for Compensation Committees* (March 30, 2011), http://www.sec.gov/rules/proposed/2011/33-9199.pdf.

In addition, CF staff is working on developing recommendations for the Commission concerning the implementation of the following provisions of the Dodd-Frank Act:

- **Recovery of Erroneously Awarded Compensation.** Section 954 of the Dodd-Frank Act requires the Commission to adopt rules mandating new listing standards relating to specified executive compensation "clawback" policies.

- **Pay versus Performance and Pay Ratios**. Under Section 953 of the Dodd-Frank Act, the Commission must adopt rules requiring new disclosures about the relationship between executive compensation and company performance, and the ratio between the median of the annual total compensation of an issuer's employees and the annual total compensation of the issuer's chief executive officer.

- **Employee and Director Hedging**. Section 955 of the Dodd-Frank Act requires the Commission to adopt rules requiring disclosure by issuers of their policies relating to certain employee and director hedging activities.

Specialized Disclosures. Title XV of the Dodd-Frank Act contains specialized disclosure provisions related to conflict minerals, coal or other mine safety, and payments by resource extraction issuers to foreign or U.S. government entities. The Commission published the rule proposals relating to these three provisions in December 2010[12] and the comment period ended on March 2, 2011. The Commission recently held a public roundtable regarding the conflict minerals rulemaking, and reopened the comment period from October 6, 2011 until November 1, 2011 in connection with the roundtable. The staff is preparing final rule recommendations for the Commission on these three rulemakings.

Exempt Offerings.

- **Accredited Investor.** Section 413(a) of the Dodd-Frank Act requires the definition of "accredited investor" in the Commission's 1933 Act rules to exclude the value of a person's primary residence for purposes of determining accredited investor status on the basis of having net worth in excess of $1 million. The Commission proposed rule amendments on January 25, 2011 that would implement this provision, and would clarify the treatment of any indebtedness secured by the residence in the net worth calculation.[13] The comment period on this proposal ended on March 11, 2011 and the staff is preparing final rule recommendations for the Commission.

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[12] *See* Release No. 34-63547, *Conflict Minerals* (December 15, 2010), http://www.sec.gov/rules/proposed/2010/34-63547.pdf; Release No. 33-9164, *Mine Safety Disclosure* (December 15, 2010), http://www.sec.gov/rules/proposed/2010/33-9164.pdf, Release No. 34-63549, *Disclosure of Payments by Resource Extraction Issuers* (December 15, 2010), http://www.sec.gov/rules/proposed/2010/34-63549.pdf.

[13] *See* Release No. 33-9177, *Net Worth Standard for Accredited Investors* (January 25, 2011), http://www.sec.gov/rules/proposed/2011/33-9177.pdf.

- **"Felons and Other 'Bad Actors'".** Under Section 926 of the Act, the Commission is required to adopt rules that disqualify securities offerings involving certain "felons and other 'bad actors'" from relying on the safe harbor from 1933 Act registration provided by Rule 506 of Regulation D. The Commission proposed rules to implement the requirements of Section 926 on May 25, 2011,[14] and the comment period for this rule proposal ended on July 14, 2011. The staff is preparing final rule recommendations for the Commission.

Credit Rating Agencies. The Dodd-Frank Act resulted in several rulemakings related to nationally recognized statistical rating organizations. In July 2011, the Commission adopted rule amendments removing credit ratings as conditions for companies seeking to use short-form registration when registering non-convertible securities for public sale. Under the new rules, the test for eligibility to use Form S-3 or Form F-3 short-form registration is tied to the amount of debt and other non-convertible securities (other than equity) a particular company has sold in registered primary offerings within the previous three years, or that the company has outstanding that were issued in registered primary offerings.[15] In addition, in September 2010, as required by Section 939B of the Dodd-Frank Act, the Commission adopted a rule amendment to remove communications with credit rating agencies from the list of excepted communications in Regulation FD.[16]

Security-Based Swaps. CF has responsibility for certain rulemakings related to Title VII of the Dodd-Frank Act, which imposed a new regime for the regulation of OTC derivatives. This includes proposed exemptions under the 1933 Act, the 1934 Act, and the Trust Indenture Act of 1939 for security-based swaps transactions involving certain clearing agencies satisfying certain conditions, in order to facilitate clearing of security-based swaps,[17] interim exemptions from certain provisions of the federal securities laws that would otherwise have applied to security-based swaps on July 16, 2011,[18] and extension of certain existing temporary rules and relief to continue to facilitate the clearing of certain credit default swaps by clearing agencies functioning as central counterparties.[19] The Commission also readopted certain beneficial ownership rules to preserve their application to persons who purchase or sell security-based swaps.[20]

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[14] *See* Release No. 33-9211, *Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings* (May 25, 2011), http://www.sec.gov/rules/proposed/2011/33-9211.pdf.

[15] *See* Release No. 33-9245, *Security Ratings* (July 27, 2011), http://www.sec.gov/rules/final/2011/33-9245.pdf.

[16] *See* Release No. 33-9146, *Removal from Regulation FD of the Exemption for Credit Rating Agencies* (September 29, 2010), http://www.sec.gov/rules/final/2010/33-9146.pdf.

[17] *See* Release No. 33-9222, *Exemptions for Security-Based Swaps Issued by Certain Clearing Agencies* (June 9, 2011), http://www.sec.gov/rules/proposed/2011/33-9222.pdf.

[18] *See* Release No. 33-9231, *Exemptions for Security-Based Swaps*, (July 1, 2011), http://www.sec.gov/rules/interim/2011/33-9231.pdf.

[19] *See* Release No. 33-9232, *Extension of Temporary Exemptions for Eligible Credit Default Swaps to Facilitate Operation of Central Counterparties to Clear and Settle Credit Default Swaps* (July 1, 2011), http://www.sec.gov/rules/interim/2011/33-9232.pdf.

Enforcement Liaison
The Division regularly provides technical assistance to the Division of Enforcement on enforcement matters. In the 2011 fiscal year, CF responded to close to 2,000 inquiries from that Division, and referred more than 400 matters to Enforcement. In the first month of the 2012 fiscal year, CF referred more than 50 matters to Enforcement.

International Coordination
The globalization of securities markets requires CF to work with its foreign counterparts on an ongoing basis. The active participation of CF staff with technical expertise in international working groups – of, among others, the International Organization of Securities Commissions, the Financial Stability Board, and the Organization for Economic Co-operation and Development – is essential to the fulfillment of the Commission's international responsibilities. The staff works to represent the interests of US investors and markets on relevant international issues. In addition to working with international groups, there are also a number of bi-lateral relationships, such as with European regulators, which are increasingly important in today's global environment. The international work of CF also includes collaborating with other Federal agencies, such as the Federal Reserve Board and the Department of the Treasury, by providing them with technical assistance on matters related to international coordination of financial regulation.

Upcoming Challenges

While CF has developed review practices and procedures to satisfy the Sarbanes-Oxley Act review mandate,limited resources constrain the Division's ability to devote sufficient resources to the review of companies that represent the largest portion of U.S. market capitalization. The Division's limited staff is responsible for reviewing the disclosures of nearly 10,000 reporting companies under this review mandate, and also for selectively reviewing registration statements and other transactional filings made under the 1933 Act and 1934 Act, such as filings related to capital raising and business combinations. The challenges of staffing the review program are even greater in light of the Division's new responsibilities under the Dodd-Frank Act. As noted, CF is currently implementing changes to its review program with the goal of increasing its focus on large and financially significant registrants and recalibrating its reviews of smaller reporting companies in order to gain additional efficiencies, in a manner consistent with its obligations under the Sarbanes-Oxley Act. CF has also made targeted changes to its operations, including the formation of three new offices in order to better fulfill our mission of investor protection. The ability to realize these benefits will be compromised, however, if we are unable to fully staff them and/or are unable to hire additional staff to enhance our expertise in these areas.

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[20] *See* Release No. 34-64628, *Beneficial Ownership Reporting Requirements and Security-Based Swaps* (June 8, 2011), http://www.sec.gov/rules/final/2011/34-64628.pdf.

TRADING AND MARKETS

Director, Robert Cook[21]

The Division of Trading and Markets (TM) is responsible for establishing and maintaining standards for fair, orderly, and efficient markets. TM's workload is dominated by a diverse range of core functions that are vital for protecting investors and markets, and the scope of many of these functions expanded significantly under the Dodd-Frank Act. In addition, TM has taken on substantial new responsibilities as a result of the Dodd-Frank Act, in particular the implementation of a new regulatory regime governing certain over-the-counter (OTC) derivatives.

TM's Core Functions

Regulation for Securities Markets

TM devotes substantial resources to developing and maintaining appropriate regulations for the securities markets, including 15 securities exchanges (equities and options), 3 electronic communication networks (ECNs), over 60 active alternative trading systems, and over 200 internalizing broker-dealers. TM's ongoing responsibilities include:

- Reviewing new exchange registrations, an extensive process that requires analysis of, among other complex issues, the impact of a new exchange on the protection of investors, the public interest, and the national market system.
- Processing proposed SRO rule changes, which address issues ranging from new fee structures to changes in trading rules to revamped governance structures. As of last month, TM had received over 1,800 rule filings this calendar year, and we anticipate receiving over 350 more before the end of the year.[22] These filings are reviewed for consistency with the Exchange Act, including requirements for fair and orderly markets and for limiting burdens on competition. The Dodd-Frank Act imposed new procedural requirements with respect to the Commission's processing of these filings, which substantially increased TM's workload.
- Reviewing new financial products, ranging from now-common index exchange traded funds (ETFs) to physical commodity trusts to more esoteric products.
- Initiating changes to market rules to keep apace with market developments.

Over the past few years, TM has focused on several key initiatives to improve the oversight and function of our markets:

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21 Mr. Cook joined the SEC as the Director of Trading and Markets in January 2010. http://www.sec.gov/news/press/2009/2009-242.htm

22 This number includes filings by the exchanges and other SROs, such as clearing agencies, FINRA, and the MSRB.

- *Sponsored Access*. In November 2010, the Commission took an important step to promote market stability by adopting a new market access rule.[23] Broker-dealers that access the markets themselves or offer market access to customers will be required to put in place appropriate pre-trade risk management controls and supervisory procedures. The rule effectively prohibits broker-dealers from providing customers with "unfiltered" access to an exchange or alternative trading system. By helping ensure that broker-dealers appropriately control the risks of market access, the rule should help prevent broker-dealers or their customers from engaging in practices that could increase risks to the financial condition of other market participants and clearing organizations, as well as the integrity of trading on the securities markets.

- *Large Trader Reporting*. In July 2011, the Commission adopted new rules to help identify, and obtain trading information on, market participants that conduct a substantial amount of trading activity in the U.S. securities markets.[24] These new large trader reporting requirements are designed to provide the Commission with a valuable source of useful data to support: (1) its investigative and enforcement efforts; (2) reconstruction of trading activity following significant market events; and (3) analysis of the impact of large traders on the securities markets.

- *Consolidated Audit Trail*. TM is preparing recommendations for the Commission's consideration for a final rule to create, implement, and maintain a consolidated audit trail, another of the Commission's proposals to address significant shortcomings in the agency's present ability to collect and monitor trade data in an efficient and scalable manner.[25] If implemented, the consolidated audit trail would, for the first time, allow SROs and the Commission to track trade data across multiple markets, products and participants simultaneously. It would also boost regulators ability to rapidly reconstruct trading activity and to more quickly analyze both suspicious trading and unusual market events. The Commission received many informative comments on the proposed rule, which TM is taking into account in preparing its recommendations – including discussion of the benefits of a consolidated audit trail, feedback addressing the estimated cost of implementing a consolidated audit trail and proposals for possible alternatives for achieving the Commission's goals.

- *Additional Steps to Address the Events of May 6, 2010*. TM leads the Commission's efforts to monitor and respond to significant market events, such as the severe market disruption of May 6, 2010. In addition to spearheading the Commission's inquiry into that day's events, coordinating an independent joint SEC-CFTC advisory committee focusing on those events, and publishing two joint reports with the staff of the CFTC, TM recommended implementation of key regulatory responses, including: (1) a uniform circuit breaker pilot program designed to halt trading in a disorderly market; (2) pilot

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[23] *See* Release No. 34-63241, *Risk Management Controls for Brokers or Dealers with Market Access* (November 3, 2010), http://www.sec.gov/rules/final/2010/34-63241.pdf

[24] *See* Release No. 34-64976, *Large Trader Reporting* (July 27, 2011), http://www.sec.gov/rules/final/2011/34-64976.pdf

[25] *See* Release No. 34-62174, *Consolidated Audit Trail (*May 26, 2010), http://www.sec.gov/rules/proposed/2010/34-62174.pdf.

exchange rules designed to improve the process of breaking "clearly erroneous" trades; and (3) exchange rules to enhance quotation standards for market makers. In addition, TM has coordinated proposed SRO efforts to implement a "limit-up/limit-down" mechanism that would directly prevent trades outside specified parameters, while allowing trading to continue within those parameters. This procedure should prevent many anomalous trades from ever occurring, as well as limiting the disruptive effect of those that do occur. Similarly, TM has assisted the preparation of proposed updates to the market-wide circuit breakers.

- *Supporting Critical Market Infrastructure and Operations*. TM performs cyclical reviews of exchanges, ECNs, and clearing agencies to ensure they are acting in accordance with the Commission's Automation Review Policies (ARP) and have adequate systems in place to deal with technology disruptions. TM plans to enhance its ARP reviews, with a particular focus on whether registered entities have appropriate cybersecurity measures, and is preparing recommendations for the Commission to further strengthen the ARP standards.

- *Advancing a Comprehensive Review of Equity Market Structure*. In January 2010, the SEC published a concept release on equity market structure in order to solicit public input on several of the key issues highlighted by the explosive growth in trading volume: (1) the quality of performance of the current market structure; (2) high frequency trading; and (3) undisplayed liquidity in all its forms.[26] In addition to considering the more than 200 comment letters that the Commission received, TM organized a Commission-hosted public roundtable on market structure in June 2010. TM plans to continue to advance this discussion and consider whether any rulemaking responses are warranted.

Regulation for Clearing Agencies
TM currently participates in the regulation of 8 active clearing agencies that are examined by the Commission, and anticipates that a number of additional clearing agencies may become subject to Commission oversight in the next few years. TM has significant ongoing responsibilities with respect to clearing agencies, including the review of new clearing agency registration applications and rule changes; engaging in rulemaking, including adopting new prudential standards and monitoring risk-related issues utilizing the recently created Clearing Agency Monitoring group.

These responsibilities were expanded by Title VIII of the Dodd-Frank Act, which provides for enhanced oversight of financial market utilities (FMUs), including clearing agencies registered with the Commission, and payment, clearing or settlement activities that are designated as systemically important. TM worked closely with the staffs of the CFTC and the Federal Reserve Board (the Board) to propose requirements that would require clearing agencies, among other things, to maintain certain standards with respect to risk management and operations, have procedures that identify and address conflicts of interest, and require minimum governance standards for boards of directors. Many of the proposed requirements would apply to all clearing

[26] *See* Release No. 34-61358, *Concept Release on Equity Market Structure* (January 14, 2010), http://www.sec.gov/rules/concept/2010/34-61358.pdf

agencies, while others would focus more specifically on clearing agencies that clear security-based swaps.[27]

Additionally, as directed by Title VIII, TM worked jointly with the staffs of OCIE, the CFTC and the Board over the past year to develop a report to Congress reflecting recommendations regarding risk management supervision of clearing entities designated as systemically important by the FSOC. The report should establish a strong framework for ongoing consultation and cooperation in clearing agency oversight among the Commission, the CFTC, and the Board.

Regulation for Broker-Dealers

The Division is responsible for regulations governing close to 5,000 registered broker-dealers, including by:

- Establishing or approving rules governing broker-dealer activities, including rules pertaining to capital adequacy, the protection of customer assets, anti-money laundering, sales practices and record-keeping.

- Reviewing, on an ongoing basis and together with OCIE, the financial activities of certain "risk-supervised broker-dealers," and reviewing filings of other broker-dealers with respect to their material affiliates.

TM is continuing to recommend improvements to the rules in this area. Most recently, in June 2011, the Commission proposed amendments to the broker-dealer financial reporting rules, which are intended to strengthen requirements regarding broker-dealers' custody of customer funds and securities.[28] These amendments would, among other things, facilitate the ability of the PCAOB to implement oversight of independent public accountants of broker-dealers, as required by the Dodd-Frank Act, and eliminate potentially redundant requirements for certain broker-dealers affiliated with, or dually-registered as, investment advisers. The amendments also would enhance the ability of the Commission and SRO examiners to oversee broker-dealers' custody practices by requiring broker-dealers to provide additional information to the Commission.

Regulation for Credit Rating Agencies

TM currently makes rule recommendations for the Commission's consideration applicable to the several credit rating agencies registered with the Commission as NRSROs, reviews applications from potential new registrants and, in conjunction with OCIE, monitors their activities.

Under the Dodd-Frank Act, these responsibilities were expanded significantly, with the Commission required to undertake approximately a dozen rulemakings related to NRSROs. The Commission adopted the first of these required rulemakings in January, and in May, the

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27 *See* Release No. 34-64017, *Clearing Agency Standards for Operation and Governance* (March 3, 2011), http://www.sec.gov/rules/proposed/2011/34-64017.pdf.

28 *See* Release No. 34-64676, *Broker-Dealer Reports* (June 15, 2011), http://www.sec.gov/rules/proposed/2011/34-64676.pdf

Commission published for public comment a series of proposed rules that would largely implement the Dodd-Frank Act requirements by requiring NRSROs to, among other things:[29]

- Report on their internal controls;
- Better protect against any conflicts of interest;
- Establish professional standards for their credit analysts;
- Publicly provide – along with the publication of any credit rating – disclosure about the credit rating and the methodology used to determine it; and
- Provide enhanced public disclosures about the performance of their credit ratings.

The proposals also would require disclosure concerning third-party due diligence reports for asset-backed securities.

The Dodd-Frank Act also requires the SEC to conduct three studies relating to credit rating agencies. In December, the Commission requested public comment on the feasibility and desirability of standardizing credit rating terminology.[30] The Dodd-Frank Act also requires: (1) a 2012 study on alternative compensation models for rating structured finance products; and (2) a 2013 study on NRSRO independence.

With respect to alternative compensation models, the Dodd-Frank Act directs the Commission to study the credit rating process for structured finance products and the conflicts associated with the "issuer-pay" and the "subscriber-pay" models. It further requires the Commission to study the feasibility of establishing a system in which a public or private utility or a self-regulatory organization would assign NRSROs to determine the credit ratings for structured finance products. Accordingly, in May the Commission published a request for public comment on the feasibility of such a system, asking interested parties to provide comments, proposals, data, and analysis by September.[31]

TM is also working with OCIE to assist in the annual examination of each NRSRO, as mandated by the Dodd-Frank Act.

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29 *See* Release No. 34-64514, *Proposed Rules for Nationally Recognized Statistical Rating Organizations* (May 18, 2011), http://www.sec.gov/rules/proposed/2011/34-64514.pdf. The Dodd-Frank Act also requires regulatory agencies to remove references to credit ratings from their regulations and to substitute such standards of creditworthiness as the agencies determine to be appropriate. As part of a Commission-wide effort to meet this requirement, in April 2011, the Commission proposed to remove references to credit ratings in rules concerning broker-dealer financial responsibility, distributions of securities, and confirmations of transactions. *See* Release No. 34-64352, *Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934* (April 27, 2011), http://www.sec.gov/rules/proposed/2011/34-64352.pdf.

30 *See* Release No. 34-63573, *Credit Rating Standardization Study* (December 17, 2010), http://sec.gov/rules/other/2010/34-63573.pdf.

31 *See* Release No. 34-64456, *Solicitation of Comment to Assist in Study on Assigned Credit Ratings* (May 10, 2011), http://www.sec.gov/rules/other/2011/34-64456.pdf.

Regulation for the Municipal Securities Market
TM currently administers the rules of the Commission with respect to the practices of municipal securities brokers and dealers and municipal advisors. It also reviews rule filings by the Municipal Securities Rulemaking Board (MSRB), coordinates with the MSRB in rulemaking and enforcement actions, and advises the Commission on policy matters relating to the municipal bond market.[32]

Under the Dodd-Frank Act, TM is responsible for adopting rules to implement a new registration regime for municipal advisors. Specifically, as of October 1, 2010, the Act made it unlawful for any municipal advisor to provide advice to a municipality unless registered with the Commission. In September 2010, the Commission adopted an interim final rule establishing a temporary means for municipal advisors to satisfy the registration requirement.[33] In December, the Commission proposed a permanent rule creating a new process by which municipal advisors must register with the SEC.[34] The Commission received over 1,000 comment letters on the proposal, including many expressing concerns regarding the treatment of appointed officials and traditional banking products and services. TM is carefully considering all of these comments in preparing its recommendation for the Commission. In addition, working with other Divisions and offices, TM is supporting the Commission's broad-based review of the municipal securities market, including the three public field hearings held to date and the preparation of a staff report concerning the state of the market.

Enforcement Liaison
The Division regularly provides technical assistance to the Division of Enforcement on enforcement matters. In 2011, TM responded to over 950 inquiries from that Division, and we are on track to address over 1,000 inquiries this year.

Investor / Market Participant Guidance
TM also responds to calls, emails, correspondence and other communications from industry, counsel, the public, congressional staff, foreign sources and others. Last year, the Division handled roughly 15,000 such communications and processed roughly 1,000 tips, complaints, referrals, and regulated entity notices. TM also issues written interpretive guidance to market participants.

International Coordination
The globalization of securities markets requires TM to coordinate its regulatory activities with its foreign counterparts on an ongoing bilateral and multilateral basis. The active participation of

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32 The Dodd-Frank Act envisions that the credit rating agency and municipal securities functions currently being carried out by TM will eventually be folded into separate offices. The Dodd-Frank Act requires the Commission to create several offices within the Commission, including the Office of Credit Ratings, and the Office of Municipal Securities. Each of these offices is statutorily required to report directly to the Chairman, the creation of these offices is subject to approval by the Commission's appropriations subcommittees to reprogram funds for this purpose. Until reprogramming approval is received, the initial functions of the offices are being performed on a limited basis by other divisions and offices.

33 *See* Release No. 34-62824, *Temporary Registration of Municipal Advisors* (September 1, 2010), http://www.sec.gov/rules/interim/2010/34-62824.pdf.

34 *See* Release No. 34-63576, *Registration of Municipal Advisors* (December 20, 2010), http://sec.gov/rules/proposed/2010/34-63576.pdf.

TM staff with technical expertise in international working groups – with, among others, the Financial Stability Board (FSB), the International Organization of Securities Commissions (IOSCO), the Financial Action Task Force, and the Joint Forum – is essential to the fulfillment of the Commission's responsibilities. TM staff serves in a leadership capacity in a number of these groups, including, the FSB Working Group on OTC Derivatives, the Committee on Payment and Settlement Systems (CPSS)-IOSCO group on Principals for Financial Market Infrastructures, the IOSCO Standing Committee on Credit Rating Agencies, and the IOSCO Task Force on OTC Derivatives Regulation. Through such participation, the staff works to represent the interests of U.S. investors and markets on relevant international issues.

Additional Responsibilities under the Dodd-Frank Act

In addition to substantially expanding many of TM's core functions, the Dodd-Frank Act also calls for the development of: (1) a registration and regulatory regime for entities that participate in the security-based OTC derivatives market; (2) new restrictions upon proprietary trading activities of certain entities under the "Volcker Rule", as well as prohibitions involving conflicts of interest related to certain securitizations; and (3) new coordination mechanisms with other regulatory agencies, most notably through the Financial Stability Oversight Council (FSOC).

Regulation of OTC Derivatives

Title VII of the Dodd-Frank Act establishes a new regulatory regime for the OTC derivatives market and requires the Commission to write rules that address, among other things: business conduct, capital, and margin requirements for market intermediaries; mandatory clearing requirements; the operation of security-based swap data repositories and trade execution facilities; and public transparency for security-based swap price and other transaction information. To date, the Commission has proposed rules in thirteen areas required by Title VII:

- Rules prohibiting fraud and manipulation in connection with security-based swaps;[35]

- Rules regarding trade reporting, data elements, and real-time public dissemination of trade information for security-based swaps that would lay out who must report security-based swaps, what information must be reported, and where and when it must be reported;[36]

- Rules regarding the obligations of security-based swap data repositories that would require them to register with the SEC and specify the extensive confidentiality and other requirements with which they must comply;[37]

[35] *See* Release No. 34-63236, *Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps* (November 3, 2010), http://www.sec.gov/rules/proposed/2010/34-63236.pdf.

[36] *See* Release No. 34-63346, *Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information* (November 19, 2010), http://www.sec.gov/rules/proposed/2010/34-63346.pdf.

[37] *See* Release No. 34-63347, *Security-Based Swap Data Repository Registration, Duties, and Core Principles* (November 19, 2010), http://www.sec.gov/rules/proposed/2010/34-63347.pdf.

- Joint rules with the CFTC regarding the definitions of swap and security-based swap dealers, and major swap and security-based swap participants;[38]

- Rules relating to mandatory clearing of security-based swaps that would establish a process for clearing agencies to provide information to the SEC about security-based swaps that the clearing agencies plan to accept for clearing;[39]

- Rules regarding the exception to the mandatory clearing requirement for hedging by end users that would specify the steps that end users must follow, as required under the Act, to notify the SEC of how they generally meet their financial obligations when engaging in security-based swap transactions exempt from the mandatory clearing requirement;[40]

- Rules defining and regulating security-based swap execution facilities, which specify their registration requirements, and establish the duties and implement the core principles for security-based swap execution facilities specified in the Act;[41]

- Rules regarding the confirmation of security-based swap transactions that would govern the way in which certain of these transactions are acknowledged and verified by the parties who enter into them;[42]

- Rules regarding certain standards that clearing agencies would be required to maintain with respect to, among other things, their risk management and operations;[43]

- Joint rules with the CFTC regarding further definitions of the terms "swap", "security-based swap," and "security-based swap agreement"; the regulation of mixed swaps; and security-based swap agreement recordkeeping;[44]

- Rules regarding business conduct that would establish certain minimum standards of conduct for security-based swap dealers and major security-based swap participants,

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38 *See* Release No. 34-63452, *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap participant" and "Eligible Contract Participant"* (December 7, 2010), http://www.sec.gov/rules/proposed/2010/34-63452.pdf.

39 *See* Release No. 63557, *Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations* (December 15, 2010), http://www.sec.gov/rules/proposed/2010/34-63557.pdf.

40 *See* Release No. 34-63556, *End-User Exception of Mandatory Clearing of Security-Based Swaps* (December 15, 2010), http://www.sec.gov/rules/proposed/2010/34-63556.pdf.

41 *See* Release No. 34-63825, *Registration and Regulation of Security-Based Swap Execution Facilities* (February 2, 2011), http://www.sec.gov/rules/proposed/2011/34-63825.pdf.

42 *See* Release No. 34-63727, *Trade Acknowledgment and Verification on Security-Based Swap Transactions* (January 14, 2011), http://www.sec.gov/rules/proposed/2011/34-63727.pdf.

43 *See* Release No. 34-64017, *Clearing Agency Standards for Operation and Governance* (March 2, 2011), http://www.sec.gov/rules/proposed/2011/34-64017.pdf.

44 *See* Release No. 33-9204, *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping* (April 29, 2011), http://www.sec.gov/rules/proposed/2011/33-9204.pdf.

including in connection with their dealings with "special entities", which include municipalities, pension plans, endowments and similar entities;[45]

- Rules regarding the registration process for security-based swap dealers and major security-based swap participants;[46] and

- Rules intended to address conflicts of interest at security-based swap clearing agencies, security-based swap execution facilities, and exchanges that trade security-based swaps.[47]

The Commission also adopted an interim final rule regarding the reporting of outstanding security-based swaps entered into prior to the date of enactment of the Dodd-Frank Act.[48] TM is continuing to develop other proposed rules required by Title VII for the Commission's consideration, including proposals to address capital, margin, and segregation requirements. Additionally, the Division is working to develop proposed rules concerning the treatment of cross-border security-based swap transactions, as well as an implementation plan that will aim to permit the roll-out of the new security-based swap requirements in a logical, progressive, and efficient manner.

Going forward, TM's regulatory responsibilities will be significantly expanded by the addition of the new categories of registered entities, the required regulatory reporting and public dissemination of security-based swap data, and the mandatory clearing of security-based swaps. In coordination with OCIE and the other Divisions, TM will be responsible for the registration and other rules for four entirely new categories of entities: security-based swap execution facilities (SEFs) (an estimated 20 new registrants within a year of the adoption of final rules); security-based swap data repositories (SDRs) (an estimated three new registrants within a year of the adoption of final rules); security-based swap dealers (an estimated 50 new registrants within a year of adoption of final rules); and major security-based swap participants. TM also will need to: (1) monitor market developments and develop new rules for Commission consideration and provide guidance where needed; (2) respond to numerous interpretive requests in connection with the requirements applicable to the new registrants; and (3) as applicable, review new rule and product submissions by security-based swap execution facilities.

Volcker Rule & Conflicts of Interest in Certain Securitizations

Volcker Rule. In January 2011, FSOC approved and released to the public a study formalizing its findings and recommendations for implementing Section 619 of the Dodd-Frank Act,

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45 *See* Release No. 34-64766, *Business Conduct Standards for Security-Based Swaps Dealer and Major Security-Based Swap Participants* (June 29, 2011), http://www.sec.gov/rules/proposed/2011/34-64766.pdf.

46 *See* Release No. 34-65543, *Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants* (Oct. 12, 2011), http://sec.gov/rules/proposed/2011/34-65543.pdf .

47 *See* Release No. 34-63107, *Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC* (October 14, 2010), http://www.sec.gov/rules/proposed/2010/34-63107.pdf.

48 *See* Release No. 34-63094, *Reporting of Security-Based Swap Transaction Data* (October 13, 2010), http://www.sec.gov/rules/interim/2011/34-63094.pdf.

commonly referred to as the Volcker Rule.[49] Section 619, among other things, generally prohibits: (i) federally insured depository institutions and their affiliates (banking entities) from engaging in short-term proprietary trading of any security, derivative, and certain other financial instruments for a banking entity's own account and (ii) owning, sponsoring, or having certain relationships with a hedge fund or private equity fund. The Commission staff worked closely with staffs from the federal banking agencies and the CFTC in drafting proposed rules to implement Section 619, and on October 12, 2011, the Commission issued the proposal jointly with the Federal Deposit Insurance Corporation, the Board, and the Office of the Comptroller of the Currency.[50] The Commission's proposed rule would apply to banking entities that are SEC-registered broker-dealers, investment advisers, and security-based swap dealers, among others.

Under the jointly-proposed rule, transactions in certain instruments would be exempt from the prohibition on proprietary trading, including obligations of U.S. government or a U.S. government agency, government-sponsored enterprises, and state and local governments. Additionally, the proposal, like the statute, would exempt activities such as market making, underwriting, and risk-mitigating hedging.

Banking entities would be required to establish an internal compliance program subject to supervisory oversight and designed to ensure and monitor compliance with the prohibitions and restrictions of Section 619. The proposal also would require firms with significant trading operations to report to the appropriate federal supervisory agency certain quantitative measurements designed to assist the supervisory agency and banking entities in identifying prohibited proprietary trading from permitted market making-related activities, among other purposes.

Section 621. In September 2011, the Commission proposed for comment a new rule under the Securities Act of 1933 to implement the prohibition under Section 621 of the Dodd-Frank Act concerning material conflicts of interest in connection with securitizations. Section 621 prohibits entities that create and distribute asset-backed securities from engaging in transactions that involve or result in material conflicts of interest with respect to the investors in such asset-backed securities.

Interagency Coordination
In addition to the supervision of FMUs described above, TM is significantly engaged in additional new interagency projects mandated by the Dodd-Frank Act, including the designation of systemically important non-bank financial entities and the design of mechanisms for the orderly liquidation of broker-dealers under new liquidation authority afforded FSOC and the FDIC. This coordination, which involves complex, interagency regulatory issues, is expected to continue into 2012 and beyond.

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[49] The FSOC Volcker Rule study and recommendations can be found at http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf. *See also* http://sec.gov/spotlight/dodd-frank/volckerrule.htm.

[50] *See* Release No. 34-65545, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships with, Hedge Funds and Private Equity Funds (October 12, 2011), http://www.sec.gov/rules/proposed/2011/34-65545.pdf.*

OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS
Director, Carlo di Florio [51]

The Office of Compliance Inspections and Examinations (OCIE) supports the SEC's mission to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation by conducting risk-based examinations across the country through the Commission's National Examination Program ("NEP"). These examinations cover investment advisers, investment companies, broker-dealers, municipal advisors, municipal securities dealers, transfer agents, credit rating agencies, clearing agencies, exchanges, and other SROs such as FINRA, and the MSRB. The results of OCIE's examinations are utilized by the Commission to inform rule-making initiatives, to identify and monitor risks, to improve industry practices and to pursue misconduct.

Recent Internal Reforms

Over the past two years, OCIE has undertaken a broad self-assessment of its strategy, structure, people, processes and technology. This has resulted in a comprehensive improvement plan to break down silos and promote a high-performance culture. OCIE continues to implement key program improvement initiatives in the following areas:

Strategy – Strengthening Our Governance and Risk-Focusing our National Exam Program. OCIE is implementing many reforms to an integrated National Exam Program designed to achieve consistency, effectiveness and efficiency. The cornerstone is a national governance model and enhanced risk-focused exam strategy to better allocate and leverage limited resources to their highest and best use. Both of these were implemented in 2011.

Structure – Strengthening Expertise in Critical Risk Areas. OCIE is implementing significant structural enhancements to support the National Exam Program and a risk-focused exam strategy. This restructuring will strengthen expertise and facilitate teamwork, while driving greater consistency, effectiveness and accountability. In 2011, the steps to implement this initiative included:

- Creating a centralized Risk Assessment and Surveillance Unit to enhance the ability of the National Exam Program to perform more sophisticated data analytics to identify the firms and practices that present the greatest risks to investors, markets and capital formation; and
- Enhancing the large firm monitoring program through engagement of senior management and boards on critical risk and regulatory issues, and public reports on issues that the NEP has identified as key risk concerns.

People – Recruiting Specialists, Improving Training and Strengthening Culture. OCIE has been recruiting people with new skill sets that are critical to supervising our modern capital markets. We also are building a leading practice training program. To that end,we introduced mentoring, project-based staffing, and other steps to build a culture of high-

[51] Mr. di Florio joined the SEC as the Director of OCIE in January 2010. http://www.sec.gov/news/press/2010/2010-1.htm

performance, teamwork and accountability. In 2011, the steps to implement this initiative included:

- Recruiting experts to deepen program knowledge and experience in areas such as derivatives, complex structured products, hedge funds and credit rating agencies; and
- Strengthening examiner skill sets through the development of an examiner training program.

Process – Streamlining Processes to Drive Consistency, Effectiveness and Efficiency. We are re-engineering our exam process end-to-end. This enables us to target more risk-focused examinations, enhance pre-exam preparation, improve multidisciplinary staffing, and increase field supervision. In FY 2011, we conducted approximately 1600 examinations.

Technology – Automating and Improving the Exam Process to Keep Pace with New Developments. We are focusing our technology strategy on moving from a manual to an automated exam process where possible. This includes enhancing information gathering to help automate risk assessment and surveillance and improving exam preparation and providing tools and techniques to enhance key activities associated with exam execution, such as work paper management, trade analysis and other data analytics and reporting. In 2011, we developed and brought on board a number of new tools and technologies to enhance program efficiency and effectiveness.

Governance, Enterprise Risk Management and Internal Controls. The financial crisis revealed just how dramatically risk management failures can harm investors, jeopardize market integrity and hinder capital formation. It also revealed the need for better oversight of risk at the board and senior management levels, and the need for stronger independence, standing and authority among a firm's internal risk management, control and compliance functions. As a result, where appropriate we focus our exams on the overall governance and risk management framework of a firm so we can assess the firm's system of checks and balances.

National Examination Program Strategic Objectives

The National Exam Program seeks to advance the SEC's mission through risk-focused strategies that (1) improve compliance; (2) prevent fraud; (3) inform policy, and (4) monitor firm-wide and systemic risk. In the coming fiscal year we will pursue our four strategic objectives by further implementing our risk-based examination strategy, addressing the implementation of Dodd-Frank Act requirements, and enhancing intra-agency and inter-agency coordination.

Further Implement Risk-Focused Exam Strategy. The NEP considers the national exam priorities and information from multiple sources to identify focus areas to review as well as which registrants to examine. We will tailor the scope of our examinations based on identified risks through our understanding of, for example, the registrant's business model (e.g., revenue streams, profit centers, products, business plans), affiliations and conflicts of interest, and control environment. OCIE now reviews and evaluates tips, complaints and referrals in accordance with the new national TCR system and related policies. Particular attention is given to TCRs that provide allegations or indications of fraud and surprise custody audits that identify qualified opinions and material discrepancies. This process helps inform the selection of registrants for examination and the scope of such exams.

As we identify risk trends or emerging risks in the course of the examination program, we will communicate this information to our examination staff. We will also publish reports and risk alerts describing notable risks, as well as observations about effective methods for addressing these risks that the NEP staff has observed. Through these public reports we will seek to encourage and strengthen the effectiveness of registrants' risk management and compliance programs in recognizing and appropriately addressing key risks.

Implement Dodd-Frank Act Requirements. The Dodd-Frank Act imposes significant additional responsibilities on the NEP, including the registration and examination of new entities, such as certain private fund advisers, private equity firms, municipal advisors and five new categories of swap/derivatives registrants. In addition, the Dodd-Frank Act significantly increases oversight expectations with regard to existing registrants, such as credit rating agencies, clearing agencies and FINRA. In FY 2012, the NEP will continue to adapt its infrastructure (e.g., examination tools and techniques, as well as other resources) to effectively accomplish the Dodd-Frank mandates, as well as contribute more broadly to the agency's work on rulemaking, related studies, and implementation of the Dodd-Frank Act.

Enhance Intra-Agency and Inter-Agency Coordination. We will continue to collaborate with staff from the other Divisions and Offices as well as our regulatory counterparts, to share information, identify areas of interest or potential regulatory risk, and coordinate examinations. Within the Commission, we have been working closely with colleagues in other divisions and offices at all levels. For example, in addition to giving input in myriad rulemakings, we have conducted numerous joint training exercises, been in almost constant contact with other divisions on changes to forms such as ADV, FOCUS and BD, as well as on examination priorities, planning and review, and made joint inquiries to the industry in response to emergency issues, such as the May 6, 2010 Flash Crash or MF Global. Our collaboration with the Division of Enforcement has been particularly close. We have formed joint referral committees to make sure that there is close communication on referrals from the moment they are made through the course of any ensuing investigation.

Outside the SEC, we have collaborated with SROs, firms, regulatory counterparts at federal banking agencies, the CFTC, and state regulators on a wide range of examination priorities and regulatory initiatives. For example, pursuant to Section 813 of the Dodd-Frank Act, on July 21, 2011 the Commission reported jointly to Congress with the CFTC and the Federal Reserve Board how we will collaborate to identify emerging risks, advance supervisor oversight, and promote enhanced risk management practices for designated clearing entities.

Programmatic Priorities for FY 2012. Pursuant to our risk-based approach to prioritizing examinations, we have identified certain likely areas of emphasis in each of our program areas for the coming year. These program areas are the broker-dealer exam program, the investment management exam program, the market oversight exam program, the clearance and settlement exam program, and the credit rating agency exam program.

Broker-Dealer Exam Program. This program will provide a risk-based focus to the program and also assist in selecting particular broker-dealers for examination. Since broker-dealer examinations may involve activities by enterprises with related entities registered in multiple capacities and acting in concert (e.g., broker-dealer, investment adviser, transfer agent, etc.), examination activities will be coordinated as appropriate. Some of the areas of focus include, new issue diligence, supervision of broker-dealer employees, fraud, unregistered activities, trading risks, new regulatory risks (e.g., compliance policies and procedures related to Dodd-Frank Act requirements or the new Market Access Rule), risks posed by large and complex firms, and enhanced collaboration with other regulatory authorities.

Investment Management Exam Program. The Investment Management Exam Program is responsible for examinations of numerous types of registrants. In FY2012, focus areas for the Investment Management Program include complex entities, fund governance, risk management, fraudulent activities and safety of assets, and performance and advertising.

Market Oversight Exam Program. The Market Oversight Program is responsible for examining certain SROs and other entities compliance with applicable federal securities laws and rules and the SRO's own rules. As of September 2011, the population subject to examination by Market Oversight included 15 national securities exchanges, FINRA, MSRB, PCAOB, and SIPC. The priorities in FY2012 in this area include risk assessment examinations based on SRO assessments, enhanced oversight of FINRA and other entities, Section 31 fee examinations, and examinations of potential new registrants.

Clearance and Settlement Program. The Clearance and Settlement Program currently oversees transfer agents and clearing agencies. In addition, if the Commission adopts final rules for Security-based Swap Data Repositories (SB SDRs) requiring registration with the Commission, the Clearance and Settlement Program will take on the responsibility within OCIE for conducting examinations of SB SDRs. The priorities for the Clearance and Settlement Program currently include: the Transfer Agent Program, the Clearing Agency Program and the Security-based Swap Data Repository Program

Credit Rating Agency Program. The Dodd-Frank Act requires the Commission to establish an independent "Office of Credit Ratings" to administer the Commission's rules with respect to credit rating agencies registered as NRSROs. The specific duties of this new office include annual examinations of each NRSRO and an annual report summarizing the examinations.

OCIE and TM have worked closely together to achieve the office's goals. In particular, OCIE has created an office within the NEP for NRSRO examinations. This office, with help from examiners from other OCIE examination areas and from members of TM's NRSRO monitoring unit, successfully completed the first set of annual examinations of each NRSRO, and the Commission approved publishing the staff's summary report of those examinations.

Upcoming Challenges

Our new risk-based approach is driven in part by the simple fact that our current examination resources can only cover an ever smaller portion of the registrants that we are responsible for examining. Only eight percent of registered advisers were examined in FY 2011 and approximately 38 per cent of advisers registered with the SEC have never been examined. Additionally, out of more than 160,000 broker-dealer branch offices, less than one percent of these offices are examined by either the SEC or FINRA annually.

Moreover, increases in the regulatory population and new complex products and lines of business complicate examination oversight. Examinations have grown more complex with the increased use of new complex products, including derivatives and ETFs; the growth of technology to facilitate such activities as high-frequency trading; and with the growth of "families" of financial service firms with integrated operations that include both broker-dealer and investment adviser affiliates.

Keeping up with these changes requires not only greater training and expertise, but also better technology. For example, high frequency trading has grown over the past six years from approximately 20 percent of trading volume in U.S. equities to well over 60 percent, and is likely to increase further. In order for the examination program to monitor developments in that market in a timely manner will require greater resources for data collection and processing as well as expertise to analyze these data feeds. Hedge funds and other complex financial entities and products pose similar technological challenges.

The Dodd-Frank Act shifted the responsibility for examining many smaller advisers to the states. However, the Dodd-Frank Act expanded the SEC's responsibilities by adding to its jurisdiction municipal advisors, as well as a large number of complex entities, such as five new categories of securities-based swap participants as well as hedge fund and other private fund advisers. The staff recently concluded, as a result, that the Commission likely will not have sufficient capacity in the near or long term to conduct effective examinations of registered investment advisers with adequate frequency.

The result of these changes in the registrant population will play out during FY2012. Overall, the approximately 25,000 registrants in the SEC regulated community in FY 2012 will dwarf the size of the current examination program (currently slightly less than 900 total staff nationwide). At current funding levels, we will not be able to expand our supervision of the population of current and future supervised entities.

INVESTMENT MANAGEMENT

Director, Eileen Rominger[52]

The Division of Investment Management ("IM") assists the Commission in executing its responsibility for investor protection and for promoting capital formation through oversight and regulation of America's $43 trillion investment management industry. IM's core mission is to administer the Investment Company Act of 1940 ("Investment Company Act") and the Investment Advisers Act of 1940 ("Advisers Act") and oversee and develop regulatory policy for investment advisers, mutual funds and other investment companies. IM carries out its mission through the following main programs:

[52] Ms. Rominger joined the SEC as the Director of Investment Management in February 2011. http://www.sec.gov/news/press/2011/2011-14.htm.

- ***Interpretive Advice and Exemptive Relief.*** IM provides formal and informal legal guidance in the form of interpretive and no-action letters, exemptive relief, interpretive releases, memoranda, and other letters and materials. In FY 2010, the staff closed 1,325 matters involving formal and informal legal guidance.

- ***Review of Filings.*** IM reviews filings of investments companies that register under the Investment Company Act and register their securities under the Securities Act of 1933 to both monitor and enhance compliance with disclosure and accounting requirements. The filings reviewed include initial registration statements, post-effective amendments thereto, proxy statements, and annual and period reports. In FY 2010, the staff reviewed 18,976 filings. Under Commission rules, some filings containing non-material changes or disclosure that is substantially similar to a prior filing may not be subject to staff review or may be subject to a limited review. Pursuant to requirements under the Sarbanes-Oxley Act of 2002, IM reviews the annual reports of all investment companies no less frequently than once every three years. In FY 2010, such reviews amounted to 4,741.

- ***Enforcement Liaison.*** IM regularly provides formal and informal legal and policy guidance to the Division of Enforcement on enforcement matters. In FY 2011, IM reviewed over 474 enforcement-related matters from the Division of Enforcement, and expects to review approximately the same number of enforcement-related matters in FY 2012. In addition, IM conducts reviews of disciplinary disclosures in new or amended Form ADVs filed by registered investment advisers to assess whether there are grounds to bring actions against the adviser or any of their associated persons. IM also works with the Division of Enforcement on IM-related tips, complaints and referrals.

- ***Rulemaking.*** In the last year, IM has been focusing its rulemaking program on implementing the provisions of the Dodd-Frank Act as they relate to investment companies and advisers, and, as rules are adopted, much of the work will shift to the Division's disclosure, interpretive advice and exemptive relief programs. Provided below is a list and brief description of the recent Dodd-Frank implementation rules IM was responsible for implementing.

Adopted Rules

Investment Adviser Regulation. The Dodd-Frank Act changed the population of investment advisers that must register with the Commission in two significant ways. First, the Dodd-Frank Act increased from $25 million to $100 million in assets under management the statutory threshold for Commission registration. Second, the Dodd-Frank Act eliminated the "private adviser" exemption, which exempted from registration many advisers to hedge funds and other private funds. Advisers that do not meet the new asset threshold may have to withdraw their registrations with the Commission and register instead in their home states. Furthermore, advisers to hedge funds and other private funds will be required to register with the Commission or qualify for one of the narrower exemptions added by the Dodd-Frank Act.

In June 2011, the Commission adopted new rules and rule amendments that: (1) reallocate primary responsibility for oversight of certain advisers to the states; (2) provide for an orderly transition to state registration for advisers that will no longer be eligible to register with the Commission; and (3) provide a transition period until March 30, 2012 for advisers that previously relied on the "private adviser" exemption to register with the Commission and come into compliance with the Advisers Act.[53] The staff estimates that, as a result, approximately 750 private fund advisers will have to register with the Commission and approximately 3,200 small advisers will withdraw their registrations. While the staff expects the number of registered advisers to decrease overall by 28 percent, the total assets managed by advisers registered with the Commission are expected to rise.

Concurrently, the Commission adopted rules to implement new adviser registration exemptions created by the Dodd-Frank Act.[54] The new rules implement new exemptions for advisers solely to venture capital funds (by defining the term "venture capital fund") and advisers solely to private funds with less than $150 million in assets under management in the United States. The new rules also clarify the meaning of certain terms included in the new exemption for foreign private advisers.

The Commission also adopted rules that require advisers registered with the Commission to provide information about the private funds that they advise, as well as information regarding their relationships with other affiliated financial institutions. Advisers that do not register, either because they are advising only venture capital funds or have less than $150 million in private fund assets under management in the United States, are subject to a more limited reporting obligation.

Family Offices. In June 2011, the Commission adopted a new rule defining "family offices" that will be excluded from the definition of an investment adviser under the Advisers Act and thus will not be subject to regulation under the Advisers Act.[55] Family offices are entities established by wealthy families to manage their money and provide tax and estate planning and similar services. Historically, family offices have not been required to register with the Commission because of an exemption for private advisers. The Dodd-Frank Act eliminated that exemption to enable the Commission to regulate advisers to hedge funds and other private funds (as discussed above), but included a new provision requiring the Commission to define family offices in order to exempt them from regulation under the Advisers Act. The Commission defined a family office as any firm that: (1) provides investment advice only to family members, as defined by the rule; certain key employees; and certain family entities; (2) is wholly owned by family clients, as defined by the rule, and controlled by family members or certain family entities; and (3) does not hold itself out to the public as an investment adviser.

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[53] *See* Release No. IA-3221, *Rules Implementing Amendments to the Investment Advisers Act of 1940* (June 22, 2011), http://www.sec.gov/rules/final/2011/ia-3221.pdf.

[54] *See Release No. IA-3222, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers* (June 22, 2011)), http://www.sec.gov/rules/final/2011/ia-3222.pdf.

[55] *See* Release No. IA-3220, *Family Offices* (June 22, 2011), http://www.sec.gov/rules/final/2011/ia-3220.pdf.

Form PF. The Dodd-Frank Act mandated that the Commission require private fund advisers (including hedge and private equity fund advisers) to confidentially report information about the private funds they manage for the purpose of the assessment of systemic risk by the Financial Stability Oversight Council ("FSOC"). On October 31, 2011, in a joint release with the CFTC, based on a staff consultation with staff representing members of FSOC, the Commission adopted a new rule that requires hedge fund advisers and other private fund advisers to report systemic risk information on a new form ("Form PF").[56] Under the new rule, registered investment advisers managing at least $150 million in private fund assets will periodically file Form PF. The data collection would dovetail with the enhanced private fund reporting discussed above for investment advisers registered with the Commission.

The Form PF reporting requirements are scaled to the adviser. Advisers with less than a certain amount of hedge fund, liquidity fund or private equity fund assets under management will report only very basic information on an annual basis. Advisers over specified thresholds will report more information, and large hedge fund and liquidity fund advisers also will report on a quarterly basis. This approach ensures that FSOC will have a broad picture of the industry while relieving smaller advisers from much of the reporting requirements. In addition, the reporting requirements are tailored to the types of funds that an adviser manages and the potential risks those funds may present, meaning that an adviser will respond only to questions that are relevant to its business model. The Commission does not intend to make public Form PF information identifiable to any particular adviser or private fund, although the Commission may use the data in an enforcement action. The Dodd-Frank Act provides special confidentiality protections for this data. The initial stages of this reporting will begin next year.

Pay to Play. In July 2010, the Commission adopted an Advisers Act rule to address so-called "pay to play" practices in which investment advisers make campaign contributions to elected officials in order to influence the award of contracts to manage public pension plan assets and other government investment accounts.[57] In June 2011, the Commission amended the pay-to-play rule in response to Dodd-Frank Act amendments to the Advisers Act that would have narrowed the application of the rule with respect to certain advisers to private funds.[58] The Commission also amended the rule to permit an adviser to pay a registered municipal advisor, a new Dodd-Frank Act category of SEC-registrants, to solicit government entities on the adviser's behalf. Such municipal advisors, however, must be subject to a pay-to-play rule adopted by the MSRB that the Commission has determined is substantially equivalent to or more stringent than the Commission's pay-to-play rule for investment advisers.

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[56] *See* Release No. IA-3308, *Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF* (October 31, 2011), http://www.sec.gov/rules/final/2011/ia-3308.pdf.

[57] *See* Release No. IA-3043, *Political Contributions by Certain Investment Advisers* (July 1, 2010), http://www.sec.gov/rules/final/2010/ia-3043.pdf.

[58] *See* Release No. IA-3221, *Rules Implementing Amendments to the Investment Advisers Act of 1940* (June 22, 2011), http://www.sec.gov/rules/final/2011/ia-3221.pdf.

Proposed Rules

Volcker Rule. IM assisted the Commission with certain parts of the proposed rule implementing the Volcker Rule. Specifically IM focused on the provisions that relate to investments in and sponsorship of hedge funds and private equity funds by banking entities.[59]

Qualified Clients. In May 2011, the Commission proposed changes to the rule that permits investment advisers to charge clients performance fees.[60] The rule's conditions already include minimum standards, such as net worth, that clients must satisfy for the adviser to charge these fees. The proposed amendments would incorporate the revised dollar amount levels that the Commission adjusted by order this past July to account for the effects of inflation, as required by the Dodd-Frank Act. The amendments also would remove the value of a client's primary residence from the calculation of net worth.

Incentive-Based Compensation Arrangements. The Dodd-Frank Act mandated that financial regulators jointly develop rules or guidelines governing incentive-based compensation practices at certain financial institutions with balance sheet assets of $1 billion or more. On March 29, 2011, the Commission proposed a rule – substantially similar to the rules proposed by the other financial regulators around the same time – that would apply to brokers, dealers and investment advisers with balance sheet assets of at least $1 billion.[61] The proposed rule contains: (1) disclosure requirements about incentive-based compensation arrangements; (2) prohibitions on encouraging inappropriate risk; and (3) provisions concerning policies and procedures for incentive-based compensation arrangements. The comment period on the proposed rule has ended. The staff is considering the various issues raised by the large number of commenters.

Other Significant Initiatives

While IM has been focused on bringing to closure its Dodd-Frank Act related rulemakings, the Division has also been engaged in rulemakings and other initiatives outside of its Dodd-Frank agenda. The most significant of these initiatives include the following:

Use of Derivatives by Investment Companies. In August 2011, the Commission issued a concept release to seek public comment on a wide range of issues raised by the use of derivatives by mutual funds and other investment companies regulated under the Investment Company Act.[62] The concept release is a continuation of the SEC's ongoing review of mutual funds' use of derivatives announced last year. The comment period ended on November 7, 2011. After consideration of public comments, the Division will evaluate recommendations for further action by the Commission.

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59 *See* Release No. 34-65545, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships with, Hedge Funds and Private Equity Funds* (October 12, 2011), http://www.sec.gov/rules/proposed/2011/34-65545.pdf.

60 *See* Release No. IA-3198, *Investment Adviser Performance Compensation* (May 10, 2011), http://www.sec.gov/rules/proposed/2011/ia-3198.pdf.

61 *See* Release No. 34-64140, *Incentive-based Compensation Arrangements* (March 29, 2011), http://www.sec.gov/rules/proposed/2011/34-64140.pdf.

62 *See* Release No. IC-29776, *Use of Derivatives by Investment Companies under the Investment Company Act of 1940* (August 31, 2011), http://www.sec.gov/rules/concept/2011/ic-29776.pdf.

Asset-Backed Issuers under the Investment Company Act. In August 2011, the Commission also issued an advance notice of proposed rulemaking to seek public input on possible amendments to Rule 3a-7 under the Investment Company Act that the Commission might consider proposing.[63] Rule 3a-7 excludes certain issuers of asset-backed securities from having to comply with the requirements of the Investment Company Act. Among the issues that the Commission set forth for public comment is the role, if any, that credit ratings should continue to play in the context of the rule. The comment period also ended on November 7, 2011 and the Division staff is currently analyzing the comments.

Mortgage-Related Pools under the Investment Company Act. In a companion concept release to the advance notice of proposed rulemaking on Rule 3a-7 for asset-backed issuers, the Commission solicited public comment on interpretive issues relating to some real estate investment trusts and other mortgage-related pools that rely on the exclusion from regulation under the Investment Company Act set forth in Section 3(c)(5)(C) of that Act.[64] The concept release noted concerns that mortgage-related pools potentially are making judgments about their status under the Investment Company Act without sufficient Commission guidance, and that certain mortgage-related pools today appear to resemble investment companies such as closed-end funds and may not be the kinds of companies that were intended to be excluded under the statutory provision. The comment period ended on November 7, 2011 and the Division staff is currently analyzing the comments.

12b-1. In July 2010, the Commission proposed to reform the regulation of distribution fees that are paid by mutual funds and their investors.[65] These fees are a significant method of paying for the distribution of fund shares. Mutual funds paid over $10 billion in distribution fees in 2010. The Commission's proposal would establish limits on these fees, improve disclosures to investors, and promote more competition among broker-dealers in setting market-based fees. The Commission received about 2,400 comment letters in response to its proposal. Most investors and investor advocates supported the proposal, while many industry commenters argued that the proposed changes would be too costly for too little benefit. The Division is evaluating recommendations for further action by the Commission.

Target Date Funds. In June 2010, the Commission proposed changes to rules regarding fund names and marketing materials with respect to target date funds.[66] A target date fund is typically intended for investors whose retirement date is at or around the fund's stated target date. American workers increasingly rely on target date funds for their retirement needs. After consideration of public comments, the Division will evaluate whether to recommend that the Commission adopt rule changes to address target date funds.

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63 *See* Release No. IC- 29779, *Treatment of Asset-Backed Issuers under the Investment Company Act* (August 31, 2011), http://www.sec.gov/rules/concept/2011/ic-29779.pdf.

64 *See* Release No. IC-29778, *Companies Engaged in the Business of Acquiring Mortgages and Mortgage-Related Instruments* (August 31, 2011), http://www.sec.gov/rules/concept/2011/ic-29778.pdf.

65 *See* Release Nos. 33-9128, Mutual Fund Distribution Fees; Confirmations (July 21, 2010), http://www.sec.gov/rules/proposed/2010/33-9128.pdf.

66 *See* Release Nos. 33-9126, Investment Company Advertising; Target Date Retirement Fund Names and Marketing (June 16, 2010), http://www.sec.gov/rules/proposed/2010/33-9126.pdf.

Money Market Fund Rulemaking, Oversight, and Surveillance. The Commission continues its more extensive oversight and surveillance of money market funds based on detailed monthly portfolio holdings data it began collecting in November 2010. Using this data, IM is able to monitor trends in money market funds' portfolio exposures, liquidity levels and average maturities and is able to discuss these trends and any associated risks with the Commission and with staff representing members of FSOC.

In November 2010, the Commission requested comment on the options discussed in the President's Working Group Report on Money Market Fund Reform Options.[67] Commenters both discussed the options in the President's Working Group Report and raised other options for reform. In May 2011, the Commission sponsored a roundtable to discuss money market funds, systemic risk, and options for further regulatory reform to reduce their systemic risk and susceptibility to runs. IM continues to consult with their counterparts in the other agencies that comprise FSOC on options for further regulatory reform.

<u>Other Functions and Special Projects</u>.

IM also participates in international working groups and engages in other special projects, some of which are highlighted below.

International Coordination. Funds and the advisers that operate them, including private funds and private fund advisers, frequently operate on a global basis. The active participation of IM staff with technical expertise in international working groups, such as IOSCO, is essential to the fulfillment of the Commission's international responsibilities. Such participation helps promote an internationally coordinated approach and standards that are consistent with Commission policy.

Investor Testing. IM is proceeding on several fronts to engage investors about how best to provide them with useful disclosure. We are currently working with the Commission's Office of Investor Education and Advocacy to examine the effectiveness of mutual fund shareholder reports in communicating useful information to individual investors. The Commission staff is also using investor testing as part of a study mandated by Section 917 of the Dodd-Frank Act regarding financial literacy and methods to improve the timing, content, and format of disclosures to investors with respect to financial intermediaries, investment products, and investment services. Finally, the SEC staff is currently conducting investor testing as part of its rulemaking efforts on target date retirement funds.

Cross-Divisional Studies. We have undertaken a number of cross-divisional studies required by the Dodd-Frank Act, including:

- ***Investment Adviser/Broker Dealer Fiduciary Study.*** In January 2011, SEC staff completed a study required by Section 913 of the Dodd-Frank Act that, among other things, evaluated the effectiveness of existing legal or regulatory standards of care for broker dealers and investment advisers when providing personalized investment advice

[67] *See* Release No. IC-29497, President's Working Group Report on Money Market Fund Reform (November 3, 2010), http://www.sec.gov/rules/other/2010/ic-29497.pdf.

about securities to retail customers.[68] SEC staff recommended that the Commission adopt rules, consistent with Congress' grant of authority in the Dodd-Frank Act, which would apply a uniform fiduciary standard of conduct to both broker-dealers and investment advisers when providing personalized investment advice about securities to retail investors. SEC staff also recommended that the Commission consider whether certain regulations applicable to broker-dealers and investment advisers should be harmonized to add meaningful investor protection.

In light of the Commission's concerns over the potential economic impact of any rulemaking under Section 913 of the Dodd-Frank Act, Chairman Schapiro has asked a core team of economists from the Commission's Division of Risk, Strategy and Financial Innovation to study, among other things, data pertaining to the standards of conduct in place under the existing broker-dealer and investment adviser regulatory regimes to further inform the Commission. Since the Commission issued the study, this team of economists has been studying these issues, and staff has been reviewing public comments, meeting with interested parties to discuss their concerns, and requesting additional data to inform the staff's economic analysis. IM staff is participating in this process as appropriate.

- ***Study on Enhancing Investment Adviser Examinations.*** In January 2011, IM staff, with assistance from other divisions and offices, completed a study required by Section 914 of the Dodd-Frank Act that reviewed the need for enhanced examination resources for investment advisers that are registered with the Commission.[69] The staff report concluded that the Commission's examination program requires a stable and scalable source of funding, and it highlighted three options: (1) imposing user fees on SEC-registered investment advisers to fund their examinations; (2) authorizing one or more SROs to examine, subject to SEC oversight, all SEC-registered investment advisers; or (3) authorizing FINRA to examine dually registered investment advisers and broker-dealers for compliance with the Advisers Act.

Upcoming Challenges

IM staffing levels have remained flat over the past several years and currently are at the same level as they were FY 2005, despite the fact that the size and complexity of the investment management industry has grown tremendously since then. As a result, IM has staffing needs for both its core programs and new responsibilities stemming from a variety of Dodd-Frank Act provisions. In particular, IM would like to bolster its technical expertise in complex areas including derivatives, hedge funds, ETFs, asset-backed arrangements, credit analysis, portfolio management, securities analysis, mutual fund trading strategies, and investment company operations. IM also would like to enhance its oversight of money market funds and specialized

[68] Former Commissioner Casey and Commissioner Paredes did not support release of the study as published and issued a separate statement in conjunction with publication of this study. The study is available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf. The statement by Commissioners Casey and Paredes is available at http://www.sec.gov/news/speech/2011/spch012211klctap.htm.

[69] The study is available at http://www.sec.gov/news/studies/2011/914studyfinal.pdf. A separate statement by Commissioner Walter is available at http://www.sec.gov/news/speech/2011/spch011911ebw.pdf.

products such as ETFs. The core program needs alone have put strain on existing resources and the Division continues to face challenges with allocating sufficient staff resources to additional responsibilities arising from the Dodd-Frank Act.

RISK, STRATEGY, AND FINANCIAL INNOVATION

Chief Economist and Director, Craig Lewis[70]

The Division of Risk, Strategy, and Financial Innovation (RSFI) was created as part of the agency's modernization initiative to share expertise and bring together critical data from across the agency. The Division was established in September 2009 to provide the Commission and its staff with sophisticated analysis that integrates economic, financial, and legal expertise. As part of this mandate, RSFI provides economic analyses as part of the Commission's rulemaking process, and supports its rule review, examination and enforcement programs with data-driven, risk-based analytical methods. It also oversees the Commission's TCR and interactive data programs. The Division has been the leader behind the agency's increased use of computerized risk analysis and inter- and intra-agency data sharing.

Economic Analysis

The Office of Economic Analysis (OEA) has the primary responsibility within the Division for providing economic analysis that supports rule making. OEA has 18 PhD economists that are dedicated to this activity. OEA is comprised of three offices that focus on particular areas of financial economics, which are similar to the areas covered by the three primary rule writing divisions: the Office of Corporation Finance, the Office of Markets, and the Office of Investments and Intermediaries.

The SEC has included cost-benefit analysis ("CBA") section in its rule releases since the early 1980s. RSFI participates in the rulemaking process by helping to develop the conceptual framing for and assisting in the subsequent writing of the its effects on the economic analysis sections. Where appropriate, the SEC "considers, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation" ("ECCF") when engaged in rulemaking.

Economic analysis of agency rules considers the key economic effects of the various alternatives that should be considered in developing regulations. Analysis of the likely economic effects of proposed rules, while critical to the rulemaking process, can be challenging. Certain costs or benefits may be difficult to quantify or value with precision, particularly those that are indirect or intangible. In light of recent court decisions, RSFI and the other divisions are examining improvements in the economic analysis the SEC employs in rulemaking. Although the existing procedures and policies are designed to provide a rigorous and transparent economic analysis, we are taking steps to improve this process so that future rules are consistent with best practices in economic analysis.

70 Dr. Lewis joined the SEC as the Chief Economist and Director of Risk, Strategy and Financial Innovation in May 2011. http://www.sec.gov/news/press/2011/2011-114.htm .

<u>Rulemaking Initiatives</u>
In addition to assisting in the preparation of economic analyses related to rulemakings, RSFI conducts special research projects to inform the Commission about key aspects of rules, and performs independent research to investigate issues of relevance to the Commission. RSFI is assisting with several projects relating to market structure reform. RSFI also is conducting several concurrent analyses of smaller reporting and private companies to better understand the effects of the 12(g) registration requirement of 500 shareholders and $10 million in assets. This includes an investigation of non-reporting companies that publicly trade in the OTC markets. These analyses are being conducted in concert with the Division of Corporation Finance

RSFI contributed to rulemakings under the Dodd-Frank Act, including rulemakings for OTC derivatives and asset backed securities. In addition to rulemaking, the Dodd-Frank Act mandated a number of studies. RSFI has been engaged in a number of these studies, including:

- *Volcker Rule Study* – RSFI assisted SEC staff and staff from other Federal financial agencies on a Dodd-Frank-mandated, inter-agency study on effective implementation of the Volcker Rule.
- *Short Selling* – RSFI is completing the Dodd-Frank-mandated study of real time short sale position reporting and a voluntary pilot program in which new short-related marks would be reported to the Consolidated Tape. Concurrently, RSFI is conducting a second Dodd-Frank study of the state of short selling, with an emphasis on recent rule changes and fails to deliver. RSFI will also be assessing the impact of Rule 201 on the option markets, as required by that rule.
- *Extraterritoriality* – Dodd-Frank Act Section 929Y requires a study of the extent to which private rights of action under the antifraud provisions of the securities laws should be extended to conduct and transactions occurring outside the United States, including a study of the economic costs and benefits of extending a private right of action for transnational securities frauds.

<u>Rulemaking Challenges</u>
As noted, RSFI has had a significant role in many of the rules mandated by the Dodd-Frank Act. At the same time, the Division is committed to continuously improving economic analysis in Commission rulemakings and to better integrate RSI economists into the rulemaking process. While the Division is striving to fully comply with these increased demands, it faces challenges in its ability to do so given current resources.

Data-Driven Analysis and Risk Assessment
In addition to rulemaking, there are a number of data-driven responsibilities and initiatives that are specific to RSFI. The Division provides economic and statistical analysis to support all aspects of enforcement and litigation matters for Commission. RSFI has developed innovative software tools and cutting edge analytical methods that are designed to identify potential problem areas associated with investment managers that support the efforts of the Office of Compliance, Inspections, and Examinations.

The Division also oversees the TCR system and interactive data programs. RSFI is responsible for the operation, management, and governance of the system. RSFI is responsible for, among other things, generating data and statistics on how the system is operating, checking whether the system is being used properly, and helping with system development.

The interactive data program provides information contained in certain documents filed with the Commission in a structured format that makes the underlying data readily available for analysis. The Office of Interactive Data has a number of objectives that include, among others, promoting the use of interactive data, developing infrastructure and supporting rule writing to implement data tagging requirements. RSFI is responsible for producing web pages that support company filings on the EDGAR web site.

To improve efficiency, the Division has been reorganized to reassign staff that have expertise in data analysis and risk assessment into the newly formed Office of Quantitative Research (OQR), which will be responsible for building quantitative risk assessment models. This office has begun to build a data infrastructure to facilitate the development and support of analytics utilizing data that is collected by the Commission. OQR houses subject matter experts that include three PhDs with degrees in Economics and Mathematics and nine financial analysts that have significant industry experience

The Office of Litigation Support (OLS) provides economic and statistical analysis to support all aspects of enforcement and litigation matters for the Commission. OLS is comprised of subject-matter experts that include five PhD economists, three senior analysts that have significant industry experience, and two junior analysts.

<u>Litigation Support, Data Analysis, and Risk Assessment Initiatives</u>
The data analysis and risk assessment functions of RSFI contribute to initiatives and activities of divisions and offices across the SEC:

- *Enforcement cases*: RSFI staff designs and implements analytical tools to assist the Division of Enforcement to identify and quantify potential violations, including insider trading and front-running. RSFI staff is frequently consulted as expert witnesses in Commission actions.
- *Insider Trading Prosecutions* – Recently, RSFI staff provided support to Federal prosecutors in the successful prosecution of Raj Rajaratnam for insider trading. RSFI staff assisted these prosecutors with analyzing expert testimony and other documents proffered by the Rajaratnam defense. Additionally, federal prosecutors asked an RSFI staff member to serve as a testifying expert in the insider trading case against Winifred Jiau.
- *Supreme Court Briefs* – RSFI provided statistical expertise and arguments for the amicus brief filed by the United States in *Matrixx v. Siracusano*, in which the U.S. Supreme Court defined the role of statistical significance in securities litigation. In addition, RSFI staff provided expertise for the amicus brief filed in *Erica P. John Fund v. Halliburton*, on whether fraud plaintiffs need to prove loss causation to obtain class certification.
- *Regulated Entity Risk Models* – RSFI has developed and is continuously refining risk models to help OCIE efficiently direct exam resources among investment advisers, broker-dealers, and fund complexes in light of current trends and suspected abuses.

These models are designed to identify candidates for examination and focus resources mid-exam.

- *Analytical Tools and Expertise for Examination and Investigations* – RSFI has participated in exams and investigations, and developed tools, algorithms, and analytics that enhance the effectiveness of field teams at registrants. In particular, RSFI also provides guidance to OCIE staff during examinations of investment advisers that rely on quantitative or model driven strategies to help the examiners understand these strategies.
- *Dodd-Frank Data Collections* - RSFI will handle the new data collection responsibilities mandated by the Dodd-Frank Act, which include, among other items, credit default swap data and information about private fund advisers submitted using Form PF. For example, RSFI has been preparing for this responsibility by analyzing data provided by Depository Trust and Clearing Corporation (DTCC) on a voluntary basis for more than a year.
- *New Products* – RSFI has formed a working group to evaluate risks posed by new financial products. These products come to the working group's attention through a steady work flow of SRO rule changes and exemption requests, registrations for new issuances, its own research and through referral by SEC staff.

Challenges with Expanding Data Analytic and Risk Assessment Capabilities. RSFI would like to expand its capabilities to develop risk assessment models and to build a scalable data infrastructure to support risk-based initiatives across the SEC. Although the Division plans to pursue these objectives simultaneously and has existing employees with the necessary expertise to work on these projects, resource constraints inhibit progress and significantly slow the rate of innovation. For example, projects to develop risk assessment models to detect accounting fraud have been delayed due to resource constraints.

Research

RSFI economists conduct research on financial and economic subjects relevant to the SEC's mission for publication in peer-reviewed academic journals. This work includes researching and writing papers, and presenting these papers at conferences and similar academic forums for critique. Active participation in the research community helps inform its input into Commission policy and operations and ultimately helps make the SEC a more effective regulator.

Conclusion

While the SEC has made substantial progress in reforming its operations and increasing its efficiency, our efforts are ongoing. We will continue to further improve our internal operations, and will seek the resources needed to accomplish our core mission, implement the responsibilities given to us under the Dodd-Frank Act, and undertake seriously needed new technology initiatives. Investors and our markets deserve nothing less. We look forward to continuing to work closely with Congress, and we are happy to answer any questions you may have.