SEC OVERSIGHT: CURRENT STATE AND AGENDA

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS,
INSURANCE, AND GOVERNMENT
SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

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SEC OVERSIGHT: CURRENT STATE AND AGENDA

Tuesday, July 14, 2009

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS,
INSURANCE, AND GOVERNMENT
SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Paul E. Kanjorski [chairman of the subcommittee] presiding.

Members present: Representatives Kanjorski, Ackerman, Capuano, Hinojosa, McCarthy of New York, Baca, Lynch, Maloney, Klein, Perlmutter, Donnelly, Carson, Speier, Adler, Kosmas, Himes, Peters; Garrett, Castle, Manzullo, Royce, Biggert, Capito, Hensarling, Putnam, Bachmann, McCarthy of California, Posey, and Jenkins.

Ex officio present: Representative Bachus.

Also present: Representatives Gutierrez, Moore of Kansas, Ellison, and Miller of California.

Chairman KANJORSKI. This hearing will come to order.

Pursuant to the committee rules, each side will have 15 minutes for opening statements.

Without objection, all members' opening statements will be made a part of the record.

I want to recognize Mr. Gutierrez and Mr. Ellison, members of the full committee participating in today's hearing who are not members of the subcommittee.

Without objection, it is so ordered.

We meet today to focus on the work of the U.S. Securities and Exchange Commission. Although she is no stranger to us, this hearing also represents the first time that Mary Schapiro will testify in her new capacity as the head of the Commission.

Chairman Schapiro has, of course, taken over the helm of a much beleaguered agency. In recent months, many have criticized the Commission for its lack of diligent enforcement. The Commission showed particular ineffectiveness when, despite numerous warnings, it failed to uncover the Madoff scandal. This $65 billion fraud has caused extreme hardship if not ruin for far too many individuals, pension funds, and charitable institutions.

Our panel has already examined the Madoff affair in great detail, using an unfortunate episode as a case study to examine the gaps in our existing regulatory structure and to identify solutions to fill these holes. The recent public assessments of Harry Markopoulos and the Government Accountability Office show an agency in distress. To restore investor confidence in our markets, the Commission must expeditiously change the way it does business.

Since her return to the Commission as Chairman, Mary Schapiro has moved aggressively to focus the agency on fulfilling its key mission: protecting the investors. She has beefed-up the importance of the enforcement unit, pursued significantly more enforcement actions than her immediate predecessor, and removed unnecessary hurdles that slowed progress in enforcement cases. In less than 6 months, she has also replaced nearly all of the agency senior officials.

In nominating Mary Schapiro, President Obama remarked, “Mary is known as a regulator who is both smart and tough, so much so that she has been criticized by the same industry insiders whom we need to get tough on. . . I know that Mary will provide the new ideas, new reforms, and new spirit of accountability that the SEC desperately needs so that fraud like the Madoff scandal doesn’t happen again.”

Without question, I wholeheartedly concur with the President’s assessment. In her short tenure, Chairman Schapiro has displayed a commitment to implementing the reforms needed to change the internal culture of external perceptions of the Commission.

The Commission, however, must continue to take bold and assertive action as it moves forward to bring enforcement actions against wrongdoers and to rewrite the rules governing the industry to better protect investors. Without further action to finalize regulatory proposals on proxy access, the custody of client assets, and short-sale restrictions, investors will lack the real protections that they need. The hard work on these matters therefore lies ahead.

As the Commission works to put in place new rules, Congress must also work to update our securities laws. In this regard, Chairman Schapiro has already transmitted an ambitious set of 42 legislative proposals. The Commission’s Inspector General has also offered us some ideas. And the Obama Administration has, of course, already relayed general concepts and specific legislative proposals. I am now developing a bill based on these useful recommendations.

Of the many suggestions already proposed, one important one stands out. We ought to put in place new standards that reward whistleblowers when their tips lead to catching fraudsters. By encouraging whistleblowers to come forward when they know of wrongdoing, we will leverage the Commission’s limited resources and increase the number of cops on the beat.

Improving the Commission’s overall operation and performance will additionally require a significant increase in its budget. Chairman Schapiro has noted that the agency lacks the resources required to match increasingly sophisticated markets. Fortunately, the House will soon consider a bill providing for a modest increase of 8 percent in the Commission’s 2010 budget.

But, we must do even more to remedy these constraints. The financial crisis shows what happens when unbridled capitalism lacks a strong regulatory check. We must therefore seriously consider the Commission’s request to raise its 2011 budget authorization by an additional 20 percent. Alternatively, we might decide to put the Commission on the same independent footing as other financial regulators by moving the agency outside of the appropriations process.

In closing, I look forward to Chairman Schapiro's testimony today. Her comments will help us as we embark on overhauling financial services regulation. I would like to recognize Ranking Member Garrett for 3 minutes for his opening statement.

Mr. GARRETT. I thank the chairman.

I welcome you here today and I appreciated the opportunity to meet with you on Friday to chat about some of these issues as well before today's hearing.

You know there are so many fronts on which the SEC is actively engaged, it is a little daunting to know exactly where to start. You certainly have your hands full as a new chairman of the agency, and I think it is fair to say it is under a lot of scrutiny right now for the events that have taken place over the last several months and years.

One place to start is with the SEC's budget. In the House Financial Services appropriations bill recently passed out of the committee, for the first time ever, the SEC will be funded at more than $1 billion. In a recent letter I just received from one of Bernie Madoff's group of victims, they asked why, given the SEC's recent investment protection and enforcement track record, is Congress seriously considering giving the SEC even more money and more authority to regulate financial services? I think similar questions are on a lot of people's minds, and I look forward to addressing that issue.

And the policy areas on your plate, one of the areas I have been increasingly engaged in, is the area of over-the-counter derivatives. As I said a number of times in the past, 94 percent of the 500 largest global companies use derivatives to manage risk. Policymakers therefore need to tread very carefully as we regulate options for these markets. The overregulation or improper regulations might sound good politically, I am sure, but there is a lot of major unintended negative consequences that can come about, not just for the financial markets but for the broader economy as well.

It is my understanding that the SEC and the CFTC along with the Administration have engaged in discussions over the OTC derivative regulation, including discussions regarding which agency should have jurisdiction over particular pieces of the market. So I will be interested to hear about particular discussions and any, maybe, disagreements that the SEC has with the CFTC on derivative regulation.

I am also interested to hear if there are any areas of current CFTC jurisdiction where you feel they are better suited for the SEC.

On another front, the Administration last week released draft legislation seeking to establish consistent standards for broker/dealers and investment advisors that would give the SEC powers to ban certain forms of compensation that are, quote, not in an investors' best interest. This comes on the heels, of course, of the Administration's proposals of a so-called Consumer Financial Protection Agency. When you think about it, both proposals sort of reflect a government-knows-best mentality that will likely restrict consumer choice and may be embraced by trial lawyers for unnecessary litigation. So I will be interested to hear from the Chairman regarding the SEC's input on those proposals and to what extent you are comfortable with dictating how a firm should compensate employees.

And finally, I mentioned at the beginning of my statement that there are a whole host of other issues that you are currently examining, and I will be interested to hear an update on your proposed rules to restrict short selling, as well as your thoughts on different ideas to reform credit rating agencies that we talked about, which I know the chairman is also very interested in pursuing as well. So I welcome the chairwoman being with us today, and I look forward to your discussion. Thank you.

Chairman KANJORSKI. Thank you, Mr. Garrett.

Now we will hear from the gentleman from New York, Mr. Ackerman.

Mr. ACKERMAN. Thank you, Mr. Chairman.

Welcome, Chairman Schapiro. There are an awful lot of people watching this hearing who aren't too interested in regulatory reform. They are not too concerned about resolution authority or the clearing of derivatives, and they aren't too worried about whether Congress complies with your request to increase funding for the SEC's Enforcement Division.

Madam Chairman, thousands of now penniless victims of Bernard Madoff's Ponzi scheme are interested in just one thing: making sure their government lives up to its word.

As you know, the Securities Investor Protection Corporation, that is investor protection indicating that it has something to do with protecting the investor, SIPC provides insurance of up to $500,000 to securities investors in the event that a broker/dealer fails. It has been 7 months now since the collapse of Mr. Madoff's fraud, and to date, of the over 15,400 claims that have been submitted, only 450 victims have received even a portion of their SIPC insurance. Part of the delay stems from the confusion over the eligibility requirements of SIPC coverage.

If you believe the law as interpreted by SIPC's general counsel, Josephine Wang, SIPC is obligated to provide up to $500,000 per account for securities to any investor who believes that they owned securities in Madoff's investment statements.

But if you believe Irving Picard, the court-appointed trustee in the Madoff case based on a judicial precedent from the 1920's, SIPC is obligated to ensure only the funds that Madoff victims initially invested, minus any withdrawals. According to Mr. Picard's interpretation, many Madoff victims are not entitled to their insurance payments.

Madam Chairman, that Madoff was able to conduct his fraud unmolested by the SEC for decades and despite the repeated red flags raised by Harry Markopoulos is tragic. That the court-appointed trustee in the Madoff case is seeking to delay and ultimately deny the insurance payments due to Madoff's victims is absolutely shameful.

Many of Madoff's victims are in complete financial ruin. Many have lost their homes and have moved in with their children or friends. The lucky ones don't know how to make their next mortgage payment. At a minimum, they deserve the insurance they believe and to which the law says they are entitled. I hope that you can put an end to the confusion today by clarifying SIPC's eligibility requirements.

And I yield back the balance of my time.

Chairman KANJORSKI. Thank you Mr. Ackerman.

Mr. Bachus is recognized for 3 minutes.

Mr. BACHUS. Thank you, Chairman Schapiro.

As Chairman Kanjorski said, this is your first appearance before the Financial Services Committee since you have been sworn in. And I want to compliment you; in your short tenure as the agency's chief executive, you have embarked on an ambitious regulatory agenda and an equally important review of the SEC's internal operations. And I have been impressed in a very favorable way over the way you have conducted the affairs of the agency.

Madam Chairman, there is a strong need for regulatory reform. I think we all agree on that. You certainly do. However, I am very concerned that the guiding principle of much of the Administration's proposals, whether it is health care, energy or financial services, is what could be a heavy-handed intervention into what has traditionally been the private market on private choices and private affairs.

In each of these areas, the key thing seems to be rationing or permitting certain conducts, but determining others are not appropriate. The Administration wants to create, as you know, a government health insurance option. And my fear is that if it is like those in other countries, it will result in rationing of health care, limiting choice, and erosion of quality.

The cap and tax plan, I think, is another example where they will significantly ration energy use, the use of coal and other things to discourage it.

And with financial services, it appears in many cases the Administration wants to ration credit to consumers and businesses to make determinations on whether certain transactions are appropriate, and to do so, I think, in a very intervening way.

Let me just give you one example as it relates to the SEC. With the Consumer Financial Products Agency, and this is not the example, it appears to me that they could function as a contract approval and a credit-rationing agency. That is a fear.

But now, as far as the SEC, last Friday, and I am sure you heard Treasury Secretary Geithner say that the government will be looking at every private derivative transaction that isn't clear to determine if they were spuriously customized to avoid a clearinghouse. How can the government possibly look at tens of thousands of daily derivative transactions to determine if the intention is to avoid clearing? If a derivative trade is ruled invalid and has to be unwound, what happens to the contractual rights of the parties? I worry that we are asking regulators to function as a behavioral psychologist.

Let me conclude by saying if the SEC has no one who could understand the Bernie Madoff trading strategy, how are they possibly going to be able to understand a private corporation and its counterparty's decision to mitigate business risk? What the Administration is doing is turning the SEC into an IRS where fear of second-guessing causes decisions to be made based on fear, fear of excessive punishment, and fear of having to prove the unprovable rather than basing decisions on sound business judgment.

Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you.

Mr. Capuano will be recognized for 2 minutes.

Mr. CAPUANO. Thank you, Mr. Chairman.

Madam Chairman, welcome.

Over the last couple of years, I honestly wouldn't waste my time coming to a hearing with the SEC Chair because I didn't like anything that they were not doing, because they weren't doing anything, so therefore it wasn't I didn't like what they were doing; they weren't doing anything. And it was a waste of time because everybody there believed, do nothing, let the market flow, what, no big deal. Now we are where we are.

Today, to some level, it is a little early, but on some levels, it is almost I am not sure I want to stick around too long because everything you are doing I like. Now, that doesn't mean I am going to like every detail, I am going to like the final results, and will nitpick here and there.

But, in general, I think you are going exactly in the right direction. And I will tell you that I encourage you to continue doing it. I know that you are working with the committee to try to get some legislative relief on some items that you need. I think that as—well, not an investor, but an indirect investor through 401(k)s and the like, and as a person who has some responsibility for overseeing the current system, I am much more satisfied and happy that we finally have an SEC that is awake and understands that there is a role to play to keep the system within the bounds of propriety, to keep the system so it won't break again and balancing that, obviously, with the desire and the benefits of a strong market and a strong system, with an innovative system that brings risk with it.

There is nothing wrong with risk. The question is, how much and who pays for that risk? And in general, the things you are talking about with credit rating agencies, the things you are talking about with the uptick rule, I think you are headed in the right direction. And again, I am going to stick around for your testimony just to make sure that I haven't missed something. But other than that, if I leave before I get to ask you any questions, it is not because I am not interested; it is because on some levels, I think this hearing is a little premature. Not really, but on some levels it is because a lot of these things I know they are in the works; we are in the works trying to deal with the regulatory system. And until we know where all that goes, I think some of those questions will have to wait.

But I just want to say thank you, thank you for beginning to restore—my faith in the system that we have created.

Chairman KANJORSKI. Thank you, Mr. Capuano.

Now the gentleman from California, Mr. Royce, for 3 minutes.

Mr. ROYCE. Thank you.

Thank you, Mr. Chairman, for holding this hearing.

I think it is interesting that we are talking about a 16-year timeframe that the SEC was in the process of examining or had an opportunity to examine Bernie Madoff. And I think one of the most troubling hearings that we had here was the hearing where we heard from Mr. Markopoulos about the Madoff case.

And prior to that, I had an opportunity to talk to some of the investigators for the SEC about that particular case because it was absolutely astounding what Mr. Markopoulos was telling us. What he laid out was the world's biggest Ponzi scheme and how, over a period of years, he repeatedly attempted to reach the SEC and actually found an individual at the Boston branch, Mr. Ed Manion, who was not like, as he described, the over-lawyered SEC, the over-lawyered SEC that for years had failed in this endeavor. And he finally found a guy who had experience as a portfolio manager who actually knew what he was doing, who had experience as a trader. And when he looked at this data, he instantly saw the same thing, the same reality that Mr. Markopoulos saw.

But Mr. Manion was silenced internally in the organization. Why? He wasn't a lawyer. He was not part of the over-lawyered offices in New York and Washington, and they saw to it that went nowhere.

Now, on several occasions, Mr. Markopoulos attempted on his own to go in to explain to SEC officials in detail why Mr. Madoff's returns were simply not possible given the investment strategy. And he noted, and this was the astounding aspect that I explained—the SEC investigators explained this to us, they affirmed this—there was just a lack of understanding within the SEC of the more intricate aspects of our financial markets which they just didn't understand. So what Mr. Markopoulos describes is a combination of a lack of market experience and knowledge by the over-lawyered SEC, combined with an investigative ineptitude, which we are well aware of, that aspect has to be addressed.

And to have somebody examined 8 times by the SEC and other institutions in 16 years and have this not found when people were calling attention to it shows a structural flaw. And I think rather than a lack of resources, this structural flaw is the heart of this problem. Why? Because it just didn't happen here. We also had this problem in Brittain, as described to us by some of the British investigators, where they were over-lawyered as well.

What is the proposed solution? Well, many have offered the idea of having retired people with market experience brought in so that you just don't have, in the words of Mr. Markopoulos, 20-something-year-old lawyers, so that you have people with real life experience who can spot a Ponzi scheme in a New York minute in a position of responsibility, where they can't be shut down by 20-year-old lawyers.

And so I offer that up simply because he was quite insistent on that structural change in the organization. And we are appreciative of anything you can do to reset those priorities so that you actually have people, retired, with the kind of experience with the industry and the market and who understand these schemes.

Thank you very much, Madam Chairwoman.

Chairman KANJORSKI. Thank you very much Mr. Royce.

And now we will hear from the gentleman from Texas, Mr. Hinojosa, for 1 minute.

Mr. HINOJOSA. Thank you. Thank you, Mr. Chairman.

Welcome, Madam Chair Schapiro. I want to thank Chairman Kanjorski and Ranking Member Garrett for calling and holding this important and timely hearing today. This hearing will help us understand more comprehensively the role that the SEC plays in protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital information. It is yet another step to help reassure our constituents that Members of Congress and the regulatory agencies are taking the steps necessary to address one of the causes of the global economic crisis and prevent another one from recurring.

We need to provide the SEC with a considerable amount of funding, such as that included in President Obama's proposed 2010 budget. In fact, we need to increase it beyond his proposed funding to ensure that the SEC not only is able to hire staff to fill the void at the SEC, but also increase the salary level of its employees to ensure continuity of institutional knowledge at the SEC.

Again, I want to thank you, Mr. Chairman for holding today's hearing. I look forward to the testimony of SEC Chair Mary Schapiro.

I yield back.

Chairman KANJORSKI. Thank you very much, Mr. Hinojosa.

And now we will hear from the gentleman from Texas, Mr. Hensarling, for 3 minutes.

Mr. HENSARLING. I thank you, Mr. Chairman.

And clearly this hearing is being held against the backdrop of the Administration's financial markets reform legislation. It is a piece of legislation of which many of us are concerned.

First of all, it certainly would seem to enshrine us as a bailout nation. But yet as history as our guide, I know of no nation that has been able to bail out, borrow, and spin its way into prosperity.

By designating certain firms as systemically risky, we almost guarantee that there will be more Fannie Maes and Freddie Macs, which ultimately will prove to be the mother of all bailouts, I am sure costing the American taxpayers hundreds of billions of dollars.

In addition, this Office of Consumer Financial Products, we would call it financial product polit bureau that ultimately will decide whether Americans can have credit cards, which home mortgages they can hold, whether or not they can even have access to ATM machines is regulatory overkill in the nanny state at its worse.

The underlying assumption is that our economic turmoil has somehow been caused by lack of regulation. It wasn't lack of regulation. It was dumb regulation versus smart regulation. If you come up with the wrong diagnosis, you are likely to get the wrong remedy. For example, look at the derivatives issue that was discussed just last week in a joint hearing between our committee and the Agriculture Committee.

Again, we know that the most high-profile meltdown in this area happened at AIG with their credit default swaps. Yet in sworn testimony, sworn testimony before this committee, the head of the OTS, AIG's regulators, said, do you know what? We had the expertise. We had the resources. We had the manpower, and we had the regulatory authority. We just missed it; we made a mistake.

It is another data point that it is not always more regulation that counts; it is perhaps smarter regulators and smarter regulation.

Now, others have spoken about the Madoff scandal. Clearly, again, the SEC had the tools, seemingly they had the expertise, seemingly had the manpower and, in many cases, were notified, but for whatever reason, they just missed it, and all the suffering and the setbacks to the economy have occurred.

We look at the matter of the rating agency oligopolies. And I certainly believe that some good work is being done in this area by the SEC. But for the SEC to essentially have the NRSRO rule that created an oligopoly in rating agencies contributed mightily to our economic turmoil that we see.

Again, I have a number of reservations about the Administration's plan. There are a number of areas that we can talk with the Chairman of the SEC. I appreciate her appearance today. I look forward to the testimony.

I yield back the balance of my time.

Chairman KANJORSKI. Thank you very much, Mr. Hensarling.

Now we will hear from the gentleman from Florida for 2 minutes, Mr. Klein.

Mr. KLEIN. Thank you, Mr. Chairman.

And good morning. Nice to see you again. I appreciate you taking on this important responsibility as chairman of the agency.

You have heard from a number of our members about the concerns of what has happened in the past. And I would probably respectfully disagree with some of my members. Some of this was not just a question of lack of regulation or overregulation or quality personnel. We have talked about the fact that I think that there has been a, whether it is intentional or otherwise, it seems like there has been an effort over the years by some of the Members of Congress and others to say we need less. It is not a question of less in quantity, but we don't need the smarter kind of oversight that is necessary.

And in my background, I was a securities lawyer years ago. I worked with the SEC. I understand what some of the shortcomings were and some of the strengths. But overall, I think there has been almost a deliberate attempt over the years to not compensate people at a fair level and losing some of the talent, and some of the members have recognized that.

I think as we move forward, it is not just a question of more or less; it is a question of the right type of oversight that can help investors understand what they are buying, what they are selling, and companies understand what their responsibilities are. It is not that complicated.

And I think a little common sense would go a long way here instead of sort of political posturing. This is the right thing to do at this moment.

I also want to touch briefly on the Madoff situation because there is a lot of concern. I am from Florida. A lot of people from Florida unfortunately lost a lot in this situation. And the SIPC, at least in my impression so far, has not been moving very quickly, and the trustee has not been moving as quickly as necessary to get these people made whole.

Some of these people lost everything. Some people lost part of their assets, and they are not getting responses from the SIPC. And I believe there is a responsibility of the SEC to provide statutory oversight of the SIPC. And I would ask that you with your staff take a greater role in helping resolve this as quickly as possible. We don't want to have to spend millions and millions of dollars for these people in court with lawyers. We want to get them whole, to the extent that they are permitted to be whole, with the Securities Investor Protection Act backing them up.

So I would just like to ask for that and I look forward to working with your staff and working on some new oversight regulations that will help our investors and the United States establish confidence. Thank you.

Chairman KANJORSKI. Thank you, Mr. Klein.

Now we will hear from the gentleman from California for 3 minutes, Mr. McCarthy.

Mr. MCCARTHY OF CALIFORNIA. Thank you, Mr. Chairman.

Thank you for scheduling this hearing today so we can hear from the new SEC Chair, Mary Schapiro, about your agenda. The last time this committee heard from the SEC was to discuss the Bernie Madoff scandal prior to your tenure. And I will tell you, I was frustrated with the responses that the Members received regarding the SEC handling of the Madoff Ponzi scheme. It seemed as if the right hand didn't know what the left hand was doing.

To try to fix this, I introduced legislation to restructure the SEC to return inspections and examination functions to their original location within the Division of Investment Management, Trading and Markets. This change would streamline operations at the SEC and reduce their current stovepipe structure where those charged with inspecting and examining organizations are entirely separate from those who set the policy.

With that said, I do appreciate you coming, and I look forward to a new direction and a new restructuring.

I yield back the balance of my time.

Chairman KANJORSKI. Thank you very much, Mr. McCarthy.

And now we will hear from the gentleman from Michigan, Mr. Peters, for 2 minutes.

Mr. PETERS. Thank you, Mr. Chairman.

And thank you, Chairman Schapiro, for testifying today. The current financial crisis, of course, has numerous causes. But, in my view, one of the principal concerns that must be addressed is the way in which corporations have stopped serving the interest of their shareholders.

Too often we have seen large companies run for the benefit of management and corporate boards that no longer answer to the shareholders who actually own the company. I would like to hear more today about the efforts that the SEC has undertaken pursuant to its statutory authority to empower shareholders to have more control over board elections, executive compensation packages, and other major corporate decisions.

I am also interested in hearing your thoughts about other steps that may need to be taken by Congress to supplement the efforts that the SEC is taking. This committee is currently working on comprehensive regulatory reform legislation that will give the SEC and other agencies the resources they need to look after shareholder interest.

I believe, in addition to empowering regulators with new and improved authority to watch over our Nation's financial health, we should also empower the owners of these companies to have more control and to align management interest with long-term shareholder value.

I look forward to your testimony today and having an opportunity to hear your thoughts on these very important issues.

Chairman KANJORSKI. Thank you very much, Mr. Peters.

That concludes our opening statements.

So I now with great pride introduce and welcome as our only witness at today's hearing, Mary Schapiro, Chairman of the Securities and Exchange Commission.

Without objection, your statement, Ms. Schapiro, will be made a part of the record. You are recognized for 5 minutes for a summary of your testimony. And then I suspect you should be prepared for a barrage of questions.

STATEMENT OF THE HONORABLE MARY L. SCHAPIRO, CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

Ms. SCHAPIRO. Thank you very much, Chairman Kanjorski, and thank you for your lovely introduction.

Chairman Kanjorski, Ranking Member Garrett, members of the subcommittee, thank you for the opportunity to testify today on behalf of the Securities and Exchange Commission.

In my 5 months at the SEC, we have been singularly focused on rebuilding investor confidence in the capital markets and in the SEC itself. To that end, we have begun implementing many changes designed to better serve and protect investors and promote investor confidence. Indeed, there is an invigorating sense of urgency among the staff of the agency to demonstrate that we are up to the job.

Since I returned to the agency, we have been working to fill regulatory gaps exposed by the financial crisis; seeking to strengthen the protections for investors against crimes, such as those perpetrated by Madoff and other operators of Ponzi schemes; enhancing corporate governance to hold boards more accountable to shareholders; improving our risk-assessment capabilities; bolstering our ability to respond to enforcement more quickly and effectively; and bringing on new leadership and new skill sets throughout the agency.

As I conveyed to you in February, the Madoff fraud is one that the agency tragically did not detect, and not a day goes by that we do not regret that. In a few weeks, our Inspector General will be issuing his report outlining why he believes the SEC missed the Madoff fraud. But I understood when I arrived that we could not wait to begin making significant changes. And that is why we have been implementing many new investor protections, some of which I would like to highlight.

First, we are reinvigorating the SEC's Enforcement Division by streamlining our procedures. Within days of becoming chairman, we changed our procedures so that enforcement staff can issue subpoenas and negotiate corporate penalties without first getting full Commission approval. And our enforcement focus has squarely shifted to higher-impact cases brought in a timely way.

Additionally, our new enforcement director, Rob Khuzami, is reducing bureaucracy by streamlining management within the Enforcement Division, putting many more talented investigators directly to work on cases. He is also creating specialized units which will help to concentrate staff expertise and better coordinate investigations.

Since the end of January, as compared to the same period last year, we have filed 3 times as many emergency restraining orders, opened up more than 40 additional investigations, and issued over 100 more formal orders of investigation.

In terms of cases, we have brought fraud charges against operators of the Reserve Primary Fund, which broke the buck last fall unsetting the money markets; pursued high-profile figures in connection with an alleged kickback scheme involving New York's largest pension fund; brought the first ever hedge fund insider trading case involving credit default swaps; charged the former Countrywide CEO and other former executives with securities law violations; and expanded our case involving Allen Stanford to include the former head of Antigua's financial regulatory commission, who allegedly received bribes and helped Stanford to thwart various inquiries.

This is just a small slice. There are many more investigations in the pipeline.

Second, we are strengthening our examination program. And we are doing that by recruiting more professionals with new skill sets and expertise in complex financial instruments, trading, financial analysis, risk management and valuation. Significantly enhanced training in fraud detection is also being provided to our examination staff.

Further, because we have only 425 examiners for the more than 11,000 regulated investment advisors and 8,000 mutual funds, we are improving our risk-based methodologies for detecting and focusing on potentially fraudulent firms and activities to maximize our ability to protect investors.

Third, we have proposed rules to substantially strengthen the controls of our custody of client assets held by investment advisors or their affiliates. Among other things, these custody safeguards would encourage investment firms to place their clients' assets in the care of truly independent custodians. Under the proposal, firms that do not do so would have to obtain a special custody controls report from an independent audit firm, and in addition, all advisors with control of client assets would be required to undergo annual surprise exams by independent auditors to verify client assets.

Enhancing custody controls is just one of the many rulemakings we have undertaken at the SEC. We have also sought comment on several proposals to restrict short selling. We have proposed a series of rules to empower shareholders through proxy access as well as through provision of better information in the proxy. We have sought comment on a series of money market fund reforms to tighten credit quality, maturity and liquidity standards. We have been actively considering ways to strengthen the integrity of the credit ratings process, and we have been reconsidering a decade-old proposal to challenge the so-called pay-to-play practices by investment advisors to public pension funds. And finally, tomorrow we will be considering a proposal that would result in greater and more timely information being provided to investors in municipal securities.

Mr. Chairman, I want to thank you and the committee for your support of the SEC, and I look forward to discussing with you our other activities, our thoughts for additional legislation, and the state of our resources, and reform of the regulatory landscape.

Thank you.

[The prepared statement of Chairman Schapiro can be found on page 50 of the appendix.]

Chairman KANJORSKI. Thank you very much, Madam Chairman. It sounds like you are off to a great start.

Part of the question I have is something I hear from many of my constituents, particularly after the most recent financial crisis in the country; they ask the question why, after mistakes are made by people in various positions of government, particularly in the regulatory area of government, you never seem to hear of anyone being fired?

I do not want to suggest you have wholesale firings, but what is your philosophy in terms of, if they are a failure at the agency, not only from the past but on into the future, implementing some sort of more stringent accountability to employees so that they are not necessarily lax in how they pursue enforcement or investigations. I will be honest with you, in the Madoff situation, I sympathize with the constituents of my friend from New York, Mr. Ackerman. When you hear some of the stories from the testimony of the Inspector General, that if only somebody turned around when they were examining the Madoff operation and just asked Mr. Madoff, where are the securities, that would have resolved the problem that there weren't any and therefore that there was something fraudulent going on. And yet nobody asked that question.

And now I think it is important enough to highlight so other people do not miss those questions in the future. So maybe if you could lay out your philosophy in how you intend to get a higher response to regulatory activities within the agency during your tenure.

Ms. SCHAPIRO. I would be happy to talk about that. I am a very big believer that we have to hold people accountable at all levels of the agency for performing the responsibilities that have been entrusted to us by the American people. We also have to be honest to undertake what I think we are doing right now, a very honest assessment of what were our failings and what were our shortcomings with respect to Madoff and, frankly, any other issues where we were not perhaps as quick to the draw as we should have been or could have been.

One of the things that we are engaged in right now, as you know, is the review by our Inspector General; that, I expect, will reveal much more the fundamental causes of our failure to detect early on and prevent or stop early on the Madoff fraud. In the meantime, we have tried to pull all the lessons we can, whether it is from the stovepipe structure of the organization creating issues, whether it is from a lack of skill sets so that the people who received the information from Mr. Markopoulos didn't understand what they were looking at, whether it was a resource issue, whether it was an inability to track and follow up on the material received; we tried to pull all the lessons we can from those failings and move very quickly to put in place as many different changes in how we operate as possible.

So, for example, the goal of creating specialized units within our Enforcement Division is really a response to the Madoff failure; the new custody rules to fill a gap in regulation that would have made it, if not impossible, very difficult for Madoff to do what he did. Those new rules that we have proposed are a response to that failure.

Bringing in new skill sets across the agency through our risk assessment program as well as directly into the examination program again are a response very much to the Madoff failure. The fact that we have asked this committee to create whistleblower legislation to allow us to work more closely with whistleblowers and leverage those third-party resources and expertise, again, is a very direct response.

So my view is, we have to be absolutely open to learning all the lessons that this tragedy can teach us and moving ahead to put those kinds of changes in place in a very aggressive way.

Chairman KANJORSKI. Thank you very much. I am sure that you are going to do your best.

We are going to be watching, though, I assure you of that, too.

I am going to pose my second question quickly if I can because my time is running out, but it is not done with the intention of embarrassing you or the Administration. But I am curious, should we not now take the opportunity to reform some of the structure of government, particularly by merging the CFTC and the SEC? I understand all the political ramifications, we have had meetings on end over the last several weeks on those discussions, but I asked the question the other day to the Secretary of the Treasury as to why in their White Paper they didn't discuss that seemingly natural possibility. And if we don't do it now after this disaster, what is the future plan of this Administration or Government as to what to do about what appears to be conflicting agencies that could logically be merged and accomplish better ends? I am going to end it there and not put you any further on the spot than that.

Ms. SCHAPIRO. Well, I think that the Administration having made the decision not to seek full merger of the two agencies really puts the burden on the SEC and the CFTC to work together more effectively than they have over the course of the last 35 or so years that the CFTC has been in existence. And we are both quite committed to doing that. We have been charged with an effort to harmonize our rules to the greatest extent possible, and we are fully engaged in that process right now.

But there will still be areas of uncertainty. There will still be the potential for products to be created that fall between the lines of the two agencies, and we will have to be extremely cognizant of that possibility so that we don't allow new unregulated markets to flourish between our two areas of authority.

Chairman KANJORSKI. Thank you. Again, we are going to be watching that, too.

Ms. SCHAPIRO. I appreciate that.

Chairman KANJORSKI. And that concludes my time.

And now we will hear from Mr. Garrett of New Jersey for 5 minutes.

Mr. GARRETT. I thank you.

Again, I thank the chairwoman. As the American public watches this hearing today, they probably think, in some respects, that we have been here before.

I appreciate Mr. Capuano's comment, he is gone now, where he said, in light of everything that has happened in the past, he appreciates the fact that everything is going in the right direction now, which is good.

But the public might say, well, we have been here before, because you know, if you think over history, and some of these things happened before I was in Congress, you had the mutual fund market timing issue in the past. You had the missed accounting scandals in the past. You had the analyst-conflict issues during the dot-com issues in the past. All these errors, if you will, by the SEC in the past, and I assume that there were probably other hearings like this after each one where the SEC, someone else other than you, would come back and say, we realized we have made some mistakes, and now we are going to fix them with X, Y, and Z. And probably somebody on this panel sat here and said, well, we are glad that they are now going in the right direction.

I mean, we have already talked about the Madoff situation. What somebody hasn't mentioned so far of course is the SEC is also responsible for investment bank oversight in the Bear/Lehman situations as well. So the list just continues. In one respect, it seems like the SEC is always coming in after the fact to the table, always a different chairman, saying, we realized our errors, and now we are going to try to correct them.

And that of course probably leaves the American public questioning the veracity of the SEC and also the Congress as well in order to do its job. And that probably leads to the tremendous frustration that the public has for all of this.

One of the issues that has been addressed so far is the Administration's proposal in a number of different areas. One of them is the President wants to give the SEC the power to ensure in the area of compensation. And he wants to make sure that it does not skew investment advice. So just three quick questions. Is that something that the SEC specifically asked for from the Administration for that power? If so, did you work closely to try to come up with it? And how would you try to address that issue?

Ms. SCHAPIRO. Thank you.

Let me just say that I think, to some extent, all regulators, not just the SEC, play catch-up with the fraudsters. And perhaps that will always be the unfortunate way for us to operate, although we are not going on that assumption, we are really working very hard to build a risk-assessment capability to try to get ahead of the curve of the problematic practices. And we could I guess end all problematic practices, but it would be a pretty heavy-handed regulation in order to ensure that none of them were ever perpetrated against the public.

Mr. GARRETT. Well, that is a good point. Because it can either go in the over heavy-handed approach which is suggesting what some of us suggest may be coming out of the Administration right now, or you can go in completely the other direction. Maybe we have to find in the middle where you still ask for personal responsibility from the individual in these cases. But if you can get to the point.

Ms. SCHAPIRO. Yes. What the SEC has been interested in and what we worked with the Administration on was the ability—first of all, we have done compensation disclosure rules at the SEC within the last couple of weeks to try to require forced disclosure, required disclosure, of how compensation plans incentivize long-term and short-term risk-taking within the corporation. And we have always approached compensation from a disclosure basis at the SEC.

We have sought the ability to regulate investment advisors and broker/dealers as to the standard of care that they need to provide to customers. Right now, they are actually regulated under different regimes because of their different compensation models. Investment advisors seek compensation for a fee; broker/dealers seek transactional compensation. As a result, even though they may both be providing advice to retail investors—

Mr. GARRETT. I don't have much time. Is that a fiduciary standard?

Ms. SCHAPIRO. We are looking for a fiduciary standard from the perspective of investors on getting advice from a financial services professional.

Mr. GARRETT. Again, I apologize. I don't have much time. Can an advisor receive a commission and still come under a fiduciary standard in your understanding?

Ms. SCHAPIRO. Well, advisors generally don't get compensation related—a transaction-related compensation; broker/dealers do. And what we are saying is that it should not be how they are compensated but what they are doing that gives rise to a fiduciary standard. So if you are giving advice, whether you are a broker or an investment advisor, the act of giving advice should require that you adhere to a fiduciary standard.

Mr. GARRETT. But then the aspect of the first part of the question, as far as giving you the power to set compensation schemes, would then commission-type compensation schemes go in an opposite direction from where you want to go with meeting that fiduciary standard or meeting those—making sure that it is in line with what the Administration wants to come out of this?

Ms. SCHAPIRO. I guess I am not exactly sure how directly we would set compensation schemes. We would like to see, for example, the end of retail price maintenance that would allow brokers or advisors to offer mutual funds without having to adhere to the sales prices that are quoted in the prospectus. We would like to be able to see much better disclosure with respect to compensation schemes so that investors understand exactly what it is they are paying for.

Mr. GARRETT. Thanks a lot.

Chairman KANJORSKI. Thank you, Mr. Garrett.

The gentleman from New York for 5 minutes, Mr. Ackerman.

Mr. ACKERMAN. Thank you, Mr. Chairman.

Madam Chairman, the issue that I addressed in my opening statement, to refresh your memory, is the Madoff victims and the terrible situation that we are looking at where we actually have classes of victims pitted against each other in addition to all the other confusion. Which Madoff investors are eligible for SIPC insurance?

Ms. SCHAPIRO. Congressman, let me just say that this shouldn't be such a difficult issue, but it is, and of course, it is a very heartbreaking issue, because the tragic truth is there is not enough money available to pay off all the customer claims. And as you point out—

Mr. ACKERMAN. That leaves, if I could just interject there, a larger problem because that means that our citizens are not entitled to have confidence in the system.

Ms. SCHAPIRO. Well, there is no doubt that what has happened with Madoff has shaken everybody's confidence in the integrity of the financial services industry and in the regulatory system to protect investors.

With respect specifically to the specific question, as you know, the trustee has chosen a cash in/cash out view when determining net equity on which claims and at what amount to pay out. There are a group of investors who believe that net—so that if you paid in $2 million, over time you took out $1 million, your net equity would be $1 million. There is a group of investors—

Mr. ACKERMAN. But these, unfortunately, are people that we have encouraged and assured by virtue of the fact that we provide the supervision. Now, these people knew that there were questions raised about Madoff, and the government basically gave him a clean bill of health year after year. People knew about Mr. Markopoulos. People knew about other people as well who had raised questions that were dismissed and then felt the government is saying that this guy is okay, and the million dollars I put in has grown over the years, and I have this much money to live on now.

Ms. SCHAPIRO. I understand that. And there is a group of investors who feel very deeply that their net equity on which they would be paid should be determined by looking, as you point out, at their last account statement. So they may have paid in $2 million, but that amount of money has grown to $10 million, and they were relying on that $10 million to be there for them.

Mr. ACKERMAN. Well, they weren't relying on the $2 million, which they were of course, they were relying on the government's assurance that they had the $2 million, and they made life decisions based on that.

So where do you come down, Madam Chair?

Ms. SCHAPIRO. Well, we have been meeting with SIPC and with the lawyers for the investors who would like to calculate the net equity based on the last account statement in hopes of trying to find a way to settle this matter between the two groups to expedite getting these payments out to people who are very dependent upon them. These investors have challenged the trustees' cash in/cash out methodology in court, and that is before the bankruptcy court—

Mr. ACKERMAN. We are going to have to make a decision. Someone has to make a choice here.

Ms. SCHAPIRO. I understand.

Mr. ACKERMAN. Here is a case. A woman who has a small business, a publishing business, she sells it for $3 million—she is taking out of, and that is everything she owns in the world, $3 million. It is in Madoff. She gets a check for $30,000 a month that she is taking out, which is the money she is making on it and still has the equity in there. She buys a huge apartment in Manhattan. That is the only asset that she has. The asset is now underwater. She spends the $30,000 a month paying her taxes, paying her mortgage and her maintenance and her living expenses. She has done this for a couple of years.

Suddenly one month, when Madoff turns himself in, she has no income. The unit she lives in is upside down, as they say. She can't sell it for what it is worth, she owes $15,000 to $20,000 in carrying charges and can get nothing from it if she sells it and has $1,500 in her bank and is waiting for her $30,000 return from Madoff. She is homeless. She has no assets. Her $3 million has been stolen. And then, on top of that, she is being told that the $30,000 a month that she has gotten that she has paid taxes on with half and half to her mortgage, she suddenly owes back because of a clawback thing that they are claiming.

Where is she going to get the $30,000 a month that she has collected to give back? I mean, these people are absolutely destitute. And they were reliant on the government's seal of approval that this guy is legit, that he is on the up and up. How can we turn our back on these people?

Ms. SCHAPIRO. We cannot turn our back on them, and we should not turn our back on them. And I am committed to working as aggressively as we possibly can with SIPC to take the most expansive possible view of how to repay these claims and to do it in as quick a fashion as they possibly can.

That specific issue is before the bankruptcy judge right now. I don't have, although I would be happy to get for you, some indication of timing when it might be resolved. But I agree that we need to push very hard to make people whole to the greatest extent possible.

Mr. ACKERMAN. I thank you for your concern and your actions.

Mr. Chairman, if I can just have another couple of seconds to add. Some of our colleagues have raised an accountability question. And I just want to compliment the chairman. That rather bombastic initial hearing that we had with people from the agency before us that got an awful lot of attention because it was the first one, the chairman called me immediately after the hearing and said she was aghast at some of the things that she had heard during the testimony.

Chairman KANJORSKI. You mean she called you, too?

Mr. ACKERMAN. Yes, she did, even me.

And by the end of that week, two of those people were gone from the agency. And I just want to say that is accountability that I have never seen in my 14 terms here. And I want to thank the chairman for her swift action and dedication to her mission.

Ms. SCHAPIRO. Thank you.

Mr. ACKERMAN. I yield back the balance of my time.

Chairman KANJORSKI. Thank you, Mr. Ackerman.

And now we will hear from the gentleman from Alabama, Mr. Bachus.

Mr. BACHUS. Thank you, Mr. Chairman.

Chairman Schapiro, I mentioned last Friday that Secretary Geithner made this statement that they would require regulators to carefully police any attempts by market participants to use spurious customization to avoid central clearing and exchanges.

Now, my concern is that, every day, American companies enter into hundreds if not thousands of these derivative agreements and customized derivative agreements, today, and yet there is no requirement that they clear them today. So they are not fashioning them today. They are not customizing them today to avoid this rule that the Administration says they are going to put in place.

So, number one, I mean, do you agree that this is going to be pretty complex and difficult to police these derivative agreements.

Ms. SCHAPIRO. I think that is a great question.

I do believe in the approach that should encourage the maximum standardization as possible to get as many of these instruments cleared through central clearinghouses which will reduce systemic risk pretty dramatically, even to get some of them on exchanges so we can actually have real pre- and post-trade transparency.

But I also agree that there is a need and will continue to be a need for businesses to be able to hedge their particular needs for commodities or financial protection in a customized way.

And I think we—I honestly can't tell you that I know how we would police specifically at this point, whether or not products that could have been standardized are for some other reason being customized and what we would do about that.

I do think the incentives will be there to move things into the more standardized format even without the regulators necessarily policing them, because it is envisioned that for the standardized product, the capital requirements, the margin requirements are likely to be lower, the costs of transacting are likely to be far lower than they are for the customized products.

So I believe the incentive will be for any industrial business that wants to hedge its exposure to a commodity or to a currency, for example, will be inclined to go the standardized route because it will be the most efficient thing to do.

But where it is not going to work for them, they will have to bear the additional costs, likely, of taking the customized approach. And we, as regulators, will have to figure out exactly how we are going to police them.

Mr. BACHUS. Yes. You know, he didn't say whether it was a preapproval process, which I don't think would be workable at all. I guess you would have to decide ex post facto. And, you know, to me, you would have get inside the minds of these corporations, and I am not sure that you have the expertise or could hire that expertise.

Ms. SCHAPIRO. Well, I think that the industry would have a right to expect from the regulators some significant guidance on exactly what constitutes standardized and what constitutes customized. And it would almost surely have to be a look-back and not a preapproval process.

Mr. BACHUS. But even reviewing all these customized derivatives would be an incredibly complex job.

Ms. SCHAPIRO. I don't disagree. And I can't tell you that we have thought through exactly how that would happen at this point.

Mr. BACHUS. All right. And you would have to make the business decisions that really—you know, as to what the corporations did and why they did it. And, as I said, they are doing that today, so it is not, obviously, to avoid a rule.

You are going to increase supervision of credit rating agencies. One of the things that has been talked about, preventing companies from shopping around for favorable credit ratings, how do you envision doing that?

Ms. SCHAPIRO. Well, that is an issue I am particularly interested in. As you know, the SEC has engaged in multiple rulemaking since it got authority under the Credit Rating Reform Act in 2006 to provide disclosure for the prevention and the disclosure of conflicts of interests and so forth.

But I have been particularly interested in the idea that I, as an issuer of a structured product, would like to get a good high rating for that product to be able to sell it. And so I will shop around and get preliminary ratings from multiple rating agencies and then be in a position to pick the highest rating.

One of the areas we are looking at—there are two things we are looking at specifically to respond to that. One is that we could require issuers to disclose all of those preliminary ratings so that if some of them weren't AAA, investors would at least know that.

The second would be to require on a confidential basis disclosure of the underlying loan data for a structured product, for example, to all the other rating agencies, who could then perform an unsolicited rating and make that rating available to the marketplace. So, again, you would have some competition and you would have some diversity of perspective about the quality of a particular security being brought into the marketplace.

Mr. BACHUS. All right. I think every member of this committee applauds you on your focus on credit rating agencies. I think if they had done their job properly, we could have avoided the majority of the problems we find ourselves with today. And I suppose your special examination on their role in the financial crisis will shed more light on that.

Ms. SCHAPIRO. That is right. And we are also looking at whether—because ratings are enshrined in many SEC regulations, we are looking at creating a roadmap to lessening SEC reliance on ratings in our regulatory—

Mr. BACHUS. And just the three of them, the oligarchy that I think has been set up.

Ms. SCHAPIRO. Yes, it is a highly concentrated business. I think over 95 percent of ratings are done by the top three firms.

Mr. BACHUS. Which our Republican plan also addresses.

Thank you.

Chairman KANJORSKI. Thank you, Mr. Bachus.

Now we will hear from the gentlewoman from New York, Mrs. McCarthy.

Mrs. MCCARTHY OF NEW YORK. Thank you, Mr. Chairman.

And thank you, Chairwoman Schapiro.

We have talked before, have met and asked questions back and forth, and especially on the confidence, what the SEC has to do to bring to the consumer and the investor. And I know that, you know, everybody looks at the Madoff case and how many millions and billions of dollars were lost there. What I think everybody is forgetting—and anybody who looks at their 401(k), they are not forgetting—people who were thinking of retiring can't retire; those that are retired are in dire straits.

And so your job, to build up confidence with the American people again, is going to be a difficult one. And even when we see the reaction of the financial institutions and the banks, that they don't want any of these regulations—and they are fighting us. The lobbying that is going on here is unbelievable. And yet we are supposed to be taking care of our constituents.

So one of the things that I was thinking when you were giving your testimony with regard to the many open investigations and cases the Enforcement Division is now working on, how is that being relayed to the public and the consumers. And, in your opinion, should enforcement updates fall within the CFPA, or is that something you would like to maintain within the SEC?

Ms. SCHAPIRO. Thank you.

Well, I think everything we are doing at the SEC now is geared towards trying to reorient the agency towards investor protection. We have spent a lot of time, I think historically, worrying about capital formation and the ability of U.S. businesses to compete internationally, and those are all important. But right now our focus is very much on restoring and rebuilding investor confidence which, frankly, is critical, I think, to the success of our economy over the long run.

And the important part of that, as you point out, is enforcement cases, because that shows the public we are there, on the job, trying to protect them. And we have stepped up our enforcement efforts very significantly.

We relay them to the public really through the media, and we count on the press to write about the cases that we bring, the dozens of temporary restraining order cases that we have done. Over 40 in the last several months have gotten very good publicity, particularly in local markets. And those help to both educate people going forward about the problems, but it also helps them to think of the SEC as a place where they can bring information so that we can pursue it.

I feel very strongly that the SEC's enforcement program is under terrific new leadership, a new director, a new deputy director, a new head of the New York office, a new organizational structure being rolled out over the next several weeks, new skill sets, and new resources that we hope to bring in over time will make this once again the premier civil law enforcement agency in the Federal Government.

I think the enforcement of the securities laws very much needs to stay with the Securities and Exchange Commission. And the dislocation and disruption that would be created by trying to move it into the CFPA or to take investor protection out of the SEC, in all of its different permutations because it is about so much more than just enforcement, would really leave us with a very fragmented regulatory regime.

So I would expect that if a CFPA is created, we will work very closely with that agency. There will be areas of overlap and adjacencies that we will want to coordinate on. But I feel very strongly that SEC enforcement needs to stay integrated with the rulemaking and the policy functions that we engage in.

Mrs. MCCARTHY OF NEW YORK. The final thing that I will say—and I am speaking for my constituents. They didn't lose the millions and millions of dollars that might have been invested in the Madoff scheme, but, you know, their $200,000 that they might have had in their retirement—and they are not going to get that back. You know, when reports come out that someone in their 60s, middle 60s, even higher, it will take 12 to 15 years for them to get that money back. They feel kind of burnt that they are not getting any help and they won't be getting any help. And I think that is a shame, because you are turning off an awful lot of people. There is probably more money under somebody's mattresses these days than even going into the banks, which haven't been of any help.

I hope that you are going to be able to stand up to the financial institutions. I hope that you can restore the credit to all the financial institutions, because there are a lot of good people who work in those jobs. But I have to say, the pain that the majority of my constituents and probably so many constituents around the country—they are not going to trust any of us. And, to be very honest with you, I can't blame them.

But thank you for your job, and I wish you luck in it.

Ms. SCHAPIRO. Thank you.

Chairman KANJORSKI. Thank you very much, Mrs. McCarthy.

And now the gentleman from California, Mr. Royce, for 5 minutes.

Mr. ROYCE. Thank you, Mr. Chairman.

Again, Madam Chairwoman, let me ask you a couple of questions here. And this goes to a couple of the observations that Mr. Markopolos made.

And one was the vast differences in fraud cases that he was focused on that had come from industry tips as compared to those that had come from an audit. And, clearly, his desire was to try to get resources into running down these tips that are turned in. But let me just read you what he said in his testimony here before the House and then get your comment on it.

He said, "First, I would replace the senior staff at the SEC, because they have the wrong senior staff right now. And then I would go to the bottom of the organization. You need to change who the people on these teams are down at the bottom. They can't be young 20-somethings without industry experience. You need to get higher, senior, seasoned professionals. And the third thing you need to do, you need an Office of the Whistleblower to centralize these thousands of complaints that they get so that they are handled ad hoc by 11 regional offices. You need one centralized location, the Office of the Whistleblower, instead."

That is his view on that. Now, I know some of the senior staff have stepped down since that hearing. What do you make of the other suggestions?

Ms. SCHAPIRO. I would be happy to address those. Let me start with the Office of the Whistleblower to handle complaints.

First of all, we have asked Congress to enact a whistleblower statute to give us the authority to compensate whistleblowers, in the hopes that they will bring us well-formed and well-developed evidence of fraud that the SEC can then prosecute much more quickly. And we are very hopeful that will pass, and it was also included in the Administration's legislative package.

Mr. ROYCE. And the concept of the Office of the Whistleblower instead of doing it through 11 regional—

Ms. SCHAPIRO. In fact, very shortly after I arrived, I learned that we receive between 700,000 and 1.5 million tips every year at the SEC. We are a tiny agency to handle that kind of volume. And they come in, as Mr. Markopolos points out, to every district office around the country and multiple offices in Washington. There is no central computer system. There is no tracking. There is no ability to look for a trend or a pattern of conduct across complaints coming from different areas. And there is no capability to combine that information with external sources of information.

I brought in the MITRE Corporation's Center for Enterprise Modernization almost within a month after I arrived, I believe, to do a top-to-bottom review of exactly how we are handling all of these tips and how we might get to a system that could centralize them for triage, tracking, and resolution purposes.

They have completed phase one of the work, which was a complete review of all existing processes. We are in phase two now, which will create new procedures for the entire organization. And then phase three is procurement of a technology that will provide a centralized IT solution for handling these tips agency-wide.

So we are moving very aggressively on that count.

Mr. ROYCE. Let me ask you, then, one other question he brought up, while I have time. He said he thought the SEC was "over-lawyered," to use his words. And he believed, and the SEC officials later affirmed, that there was a fundamental lack of understanding of some of the more intricate aspects of the financial markets within the SEC.

The exception to that that he cited was Ed Manion in the Boston office who had actually been a trader and been a portfolio manager but, therefore, was frozen out by the Washington and New York offices, which he viewed also as being over-lawyered.

Can you comment on this idea of the SEC being over-lawyered and whether that kept them or maybe prevented them from uncovering the Madoff incident over the years?

And I know you have taken some reform measures already, but what specifically is the SEC doing to address this problem?

Ms. SCHAPIRO. I would be happy—

Mr. ROYCE. Maybe along the lines that we had talked about with him, bringing in retired people who really had the kind of experience in the market that they could identify scams like this. Well, just like Ed Manion, you know, people like that.

Ms. SCHAPIRO. Let me start by saying that we have really an amazing staff at the SEC. We have people who are committed to their core to serving the public interest, to enforcing the law, to getting to the right answer that will serve investors. And it is important to be said because it is, in fact, true, and that is the backdrop against which all the changes are being made, that we have something very important there that we need to grow and provide the resources and the training to make better.

That said, we are recruiting actively for people with trading experience, risk management experience, portfolio valuation experience, forensic accounting, financial analysis. I mean, Wall Street's bad news, in terms of having to lay off many people, has been very much good news for the SEC. And we are able to recruit people with tremendous industry experience and expertise and bring them into the SEC. And we are taking full advantage of that opportunity right now.

Mr. ROYCE. Thank you, Chairwoman Schapiro.

Chairman KANJORSKI. And now we will hear from Mr. Lynch of Massachusetts for 5 minutes.

Mr. LYNCH. Thank you, Mr. Chairman.

Madam Chair, I thank you for your attendance at this hearing today, and I appreciate the work that you have done. I think the SEC is in good hands, and I think you have made a lot of changes in an institution that isn't necessarily inclined to change.

To follow up on Mr. Royce's questions, he talked about Mr. Markopolos's valid complaint that the SEC was over-lawyered. As well, Harvey Pitt, former chairman, as well, of the SEC, wrote a great piece called, "Over-Lawyered at the SEC" that raised a lot of the same points.

What are you doing specifically to get folks in who could help make these more, I think, financial-based analyses rather than simply a legal analysis?

Ms. SCHAPIRO. In two ways, we are actually specifically recruiting for those new skill sets to come into the agency. The first is within our examination program. As we post positions, as we have available a head count, we are actually seeking people with very particular skill sets like valuation, risk management, trading, sophisticated structured products, over-the-counter derivatives, and so forth.

Mr. LYNCH. Great, great.

Ms. SCHAPIRO. The second is that we have an Office of Risk Assessment that is quite small. We are building it rather significantly. And this year we created a risk fellows program. We have a very successful accounting fellows program. We bring in very senior people for a period perhaps only of 2 years, but to come to the agency and both train our people in very current ways of Wall Street but also to help us build risk assessment capabilities so that we can take the resources we have and focus them where they are most likely to do the maximum amount of good for the integrity of the markets and the protection of the investors.

So through the risk fellows program and through our general recruiting, we are really looking to broaden our skill sets in examination and in enforcement.

Mr. LYNCH. All right. Let me ask you then, following up on that—and that is all good news—the President's regulatory reform framework envisions an exchange for derivatives, let's call them standard linear derivatives, over an exchange, but then also custom derivatives, trading privately and in a more opaque system. These are custom derivatives; they are the more complex ones. These are the ones that generate a big payday for these banks and are custom derivatives for the individual client, and yet those are often exchanged.

So I am just wondering, from your standpoint, not from the systemic risk perspective that the Fed has to worry about, but from your standpoint, how do you think you are equipped to deal with that type of bifurcation? Are you going to be able to handle both of those situations as at least the President now envisions them?

Ms. SCHAPIRO. The SEC has a long history of dealing with both exchange-traded and centrally cleared products, as well as over-the-counter products. So I think we have the institutional expertise to do it.

I do think for the custom derivatives that are not centrally cleared, the key to success will be both transparency and the regulation of the dealers who are engaged in those transactions. So, examination of those dealers, review of their risk management processes to make sure that they are stress-testing, that they know their counterparties, that they are collecting margin, that they have credit limitations on traders, they have adequate documentation, and that they have appropriate sales practices and business conduct rules in place.

I think it is going to be really critical for the regulators, the bank regulators for many of the dealers, the SEC, for others, to have very hands-on oversight of the dealers in the customized products.

Mr. LYNCH. Okay.

Mr. Chairman, my time has expired. I yield back.

Thank you.

Chairman KANJORSKI. Thank you very much, Mr. Lynch.

Now we will hear from the gentlelady from Illinois, Mrs. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman.

And thank you, Chairman Schapiro, for being here. I have just a couple of questions.

First of all, what is your opinion of the new derivative tax that has been proposed in the recently passed cap-and-trade bill? Do you support it, or do you have fears that such a tax and additional restrictions will send U.S. businesses and jobs abroad?

Ms. SCHAPIRO. I am afraid I am not that familiar with the cap-and-trade bill. I would love to be able to come back to you with a more thoughtful response.

Mrs. BIGGERT. Could you do that in writing?

Ms. SCHAPIRO. Absolutely. Thank you.

Mrs. BIGGERT. I would appreciate that.

Then, in response to Mr. Royce's question, you mentioned forensic accounting and risk management and that you are recruiting individuals with expertise in this area. Are you also looking into new technologies and outside firms with that kind of expertise? You know, I am thinking of whether it is modeling or a central database.

Ms. SCHAPIRO. Absolutely. We have a program going on right now where our risk assessment office is reviewing multiple different technologies and services that do valuation, that can run tests of performance numbers, for example, for hedge funds and others to help us understand whether we have a pattern of improbably consistent and good results coming out of a particular investment vehicle. And it will be very important for us to enhance our technological capabilities.

I will tell you the agency's technology—well, I was a Commissioner 20 years ago at the SEC and left about 15 years ago. I haven't seen a dramatic improvement in those 15 years from when I arrived to this year. And I think, given sufficient budget resources, we really need to devote some time and attention to building the technology that will allow us to keep up with the most technologically enabled financial institutions in the world.

Mrs. BIGGERT. Thank you.

Then, last year, former SEC Chairman Chris Cox banned short-selling of stocks in nearly a thousand financial firms, and later I believe he stated that he regretted imposing the ban and that its cost appeared to exceed its benefits.

Given that these rules and comments were made at the beginning of our current financial crisis, why does the SEC now seem to think it is a good idea to heavily restrict the short-selling?

Ms. SCHAPIRO. Well, I think what Chairman Cox was referring to were outright bans on short-selling, as well as some other requirements the SEC put in place. And the analysis that was done after that period does show that, while it resulted in lower short-selling, as you would imagine, it also resulted in lower liquidity and much higher volatility.

What we are doing is quite a different thing. We are looking in a very deliberate and thoughtful way at whether reinstatement of the uptick rule that had been in place for many, many years up until 2007 ought to be reconsidered in our marketplace, which does not stop short-selling but only permits short-selling when the last prior transaction was done at a higher price.

So we are looking at reinstatement of that rule or, as an alternative, a circuit breaker, so that if a particular stock declined by, say, 10 percent, short-selling might be prohibited for a period of time thereafter in that stock.

We put all of our proposals out for comment. We had a 60-day comment period. We have gotten 4,000 comment letters that we are now working our way through to determine what our next steps might be.

Mrs. BIGGERT. So the comment period is over, and now you are—

Ms. SCHAPIRO. The comment period ended June 19th. But it is not an emergency action; it is not being done in haste. It is being done in what we believe is a very thoughtful and deliberative way. We had a roundtable publicly held and brought in all different perspectives to talk about this issue. And we are trying to take it in a very thoughtful, deliberate way.

Mrs. BIGGERT. Do you have any date for when you expect that this will be—

Ms. SCHAPIRO. I am hoping that by the end of the summer, we may be able to come back to the Commission with a proposal. I honestly don't know where the full Commission stands on the multiple proposals that we published for comment.

Mrs. BIGGERT. Okay. Thank you very much for being here.

Chairman KANJORSKI. Thank you, Mrs. Biggert.

And we will now hear from the gentlelady from California, Ms. Speier.

Ms. SPEIER. Thank you, Mr. Chairman.

And thank you, Chairman Schapiro. I have to just add my praise to all that has been showered upon you today. It is remarkable what you have done in a very short period of time.

I was astonished to read the new GAO report, though, that suggests that, in the last 3 years, the SEC has reduced the number of disgorgements by something like 80 percent and the number of enforcement actions by 60 percent.

We can't have that happen again. And I want your advice on what we should do to make sure that your agency becomes the toughest, most scrupulous cop in the Nation. And if it takes more staff, I want to give you more staff.

I am concerned by this chart here, which I presume has been given to us by you, that shows that the growth in the enforcement staff is something like 23 percent, but the growth in tips and complaints has gone up 146 percent. The growth in SEC staff is up 15 percent but the growth in trading volume is up 264 percent.

If we have learned nothing else in the last few months, it is that there wasn't the vigilance at the SEC. And so many people on Main Street are hurting today because the SEC wasn't doing its job.

Ms. SCHAPIRO. I will say on the budget that the SEC had a long period, from 2005 to 2007, of flat or declining budgets. And, in fact, even with the President's request for 2010, we will still have 4 percent fewer staff than we did in 2005.

So, in the last 2 years, Congress has been very good and very supportive of a growing SEC budget, but the fact is we are, as I said before, a pretty small agency. We have over 35,000 regulated entities; we have 3,600 employees. And that is not a great ratio by any standard. If you think about the 11,000 investment advisors and 8,000 mutual funds where so many Americans entrust their money, we have 400 examiners.

Ms. SPEIER. We need to give you more staff, and that is my point.

Next question: I am concerned about what I perceive to be a potential revolving-door problem at the SEC. Whether he was involved or not in decision-making, the attorney who was overseeing the Madoff case ends up marrying the niece of Mr. Madoff, who was also employed at the business. Another firm was being scrutinized. The particular lawyer, I believe, at the SEC then leaves the SEC and goes to work for that particular company.

I do not believe that any SEC employee who has had a responsibility over an enforcement action should be allowed to go and work for that company in the next 2 years. What is your opinion of that?

Ms. SCHAPIRO. It is a very fair question. And the revolving door is a problem for many agencies. It is a problem for the SEC, certainly.

We are looking at a couple of different models. The bank agencies have some limitations on your ability to leave the banking agencies and go into a regulated institution for some period of time. And so we are looking at those.

Here is my dilemma: I need to get the best and the brightest to come to the SEC and do what we do. And I fear that if I put too many limitations on their exits down the road, they might not be willing to come in the first instance.

So I am acutely aware of the revolving-door problem, and I would like to find a solution to it, and I haven't figured out the correct balance yet. But I am committed to working on that.

Ms. SPEIER. Rating agencies: I was astonished to find out that when they testified before our committee, they take the information that the issuer provides them and do not do any due diligence to determine whether that information is accurate or not. So, question number one, should there be a higher responsibility there?

Secondly, should there be some kind of liability that the rating agencies incur when they rate an AIG as a AAA or a Lehman at an A- and then 2 days later both of those institutions are defunct.

Ms. SCHAPIRO. Well, I will say that the SEC has very recently done rules that require disclosure about the level of due diligence that they engage in when they are rating structured products, and the extent to which they go beyond information they have been handed directly by the issuer. So hopefully that disclosure will be helpful.

I think with respect to liability, I would speak for myself and not for the SEC because I don't know the views of my colleagues on this, that I think private liability could have a very important effect on the quality of the efforts that rating agencies are making.

Ms. SPEIER. My time has expired. Thank you, Mr. Chairman.

Chairman KANJORSKI. The gentleman from Delaware, Mr. Castle, for 5 minutes.

Mr. CASTLE. Thank you, Mr. Chairman.

Chairman Kanjorski, I have an op-ed that appeared in the Financial Times, authored by Lawrence Mitchell, who is a law professor at George Washington University. I ask that it be entered into the record.

Chairman KANJORSKI. Without objection, it is so ordered.

Mr. CASTLE. Thank you, sir.

It is entitled, by the way, "Protecting Industry from Predatory Speculators." And that, Chairman Schapiro, is what I want to ask you about. And I want to cite from that article. I won't read the whole thing; it is pretty long.

But in the article, he stated, "In the first place, shareholders are hardly an oppressed class. The beneficiaries of shareholder access rules will be the pension funds and mutual funds who hold billions of dollars of corporate stock. True, they hold it on behalf of ordinary Americans, but the managers of these funds have their own interests that often conflict with those of their beneficiaries. Managers thrive by increasing their portfolios value. That is a hard thing to do, and it takes time. So, for years, fund managers have increased their pay by putting pressure on corporate managers to increase short-term stock prices at the expense of long-term business health. Doing business that way puts jobs and sustainable industry at risk, now and in the future."

He goes on and says, "For example, managers responded to the pressure by using their retained earnings to engage in large stock buy-backs. In the 3 years to September 2007, companies in the S&P 500 used more money to buy back stock than to invest in production. With retained earnings gone, all that was left to finance production was debt. When the credit markets collapsed, these corporations could not borrow and, thus, could not produce. Are boards and managers to blame? Sure. But so are the big shareholders who have been pushing management for this kind of behavior for years. They are more the problem than the solution. Enhancing their voting rights will only make things worse."

I would be interested in your comments concerning that portion of his statement.

Ms. SCHAPIRO. Okay. It is a great question.

My view on this is that, at the end of the day, the shareholders are the owners of the corporations and ought to have the ability to influence the election of directors in a meaningful way. And you and I have had some limited discussion about the Commission's new proposals on access to the proxy. But that is what our goal has been, as we have proposed ideas about which I expect we will get thousands and thousands of comment letters. But it is a view that the shareholders of the corporation are entitled to vote for directors who are overseeing management and that we need to make that as meaningful an opportunity as possible.

That said, there is clearly a lot of short-termism in the perspectives of managers and boards and shareholders, which has not necessarily been completely healthy for the U.S. economy. One of the areas we see this particularly has been with compensation plans that reward short-term risk-taking or reward short-term results to the detriment of longer-term planning and investment and R&D.

And through our new compensation disclosures proposals, we are hoping to get at some of those issues in a very direct way that will allow shareholders to see the benefits of compensation plans that promote a longer-term perspective on the affairs of the corporation and less short-term focus.

Mr. CASTLE. I, first of all, agree with your answer. I am very concerned that, in the name of small shareholders, that we are encouraging a lot of shareholder and proxy involvement when it may not be beneficial, even to the small shareholders. Obviously, a lot of the bigger shareholders are trying to drive this, and I would hope that we keep that balance in mind. I am aware that, you know, the stockholders are ultimately the owners and should have some proxy rights and control. But, on the other hand, we certainly don't want decisions being made by corporations which could end up being counterproductive.

So I appreciate your answer. I hope we will keep an eye on this as time goes by.

If I could just ask quickly, some would suggest that, if that the SEC repealed mark-to-market accounting and reinstated the uptick rule, that capital markets would return to normal. Is this an oversimplification of a rather complex issue? And your thoughts on those two subjects?

Ms. SCHAPIRO. Yes, I would say it is rather an oversimplification.

I think the uptick rule we are obviously exploring very carefully. You know, when the SEC took the uptick rule off several years ago, it was one of the most thoughtful, careful rule-makings that probably had almost ever been done. There was a pilot period, there were economic studies, there were multiple roundtables held, there were, you know, comment periods and so forth.

Nonetheless, the markets have changed rather dramatically since that period of time, and investor confidence is something we have to be very concerned about. And so, that is why we are doing this very careful examination of the uptick rule. And I am not clear at all, as I said before, where we will land with that.

On the accounting issues, the SEC did a study at the end of last year, before my time, on fair value accounting. And one of the takeaways from it, while there were things to be tinkered with around the edges, was that investors, who we very much need in our marketplace and corporations need in order to raise money, value fair value accounting. It is important to them in making investment decisions. And the idea that we could eliminate fair value accounting and solve our problems—I think we would create many, many more problems down the road.

So I think the approach that has been taken with respect to fair value, to provide interpretive guidance and other assistance from FASB, I think has helped alleviate some of the pressure on that issue.

Mr. CASTLE. Thank you.

And I yield back, Mr. Chairman.

Chairman KANJORSKI. The gentleman from New Jersey, Mr. Adler.

Mr. ADLER. Thank you, Mr. Chairman.

Madam Chairwoman, for a number of years, predating your time at the SEC, there has been some sense from the regulated community that the Commission was very good at nitpicking and not so good at catching some of the bigger things.

I don't want to refer specifically to the Madoff situation because I think, for a number of years before that, there was just a sense that personnel at the Commission were very good at finding little detailed mistakes and doing enforcement with respect to those detailed mistakes but weren't so good at seeing the bigger problems that might be present there.

Do you have a sense of whether that is a fair criticism of the Commission predating your time, whether you think it is an ongoing program, and, if you think it is a problem, how you think you can combat that?

Ms. SCHAPIRO. I don't think it is an entirely fair criticism. I think the agency, over the last several years, has brought some very important and some very major cases, with respect to the Foreign Corrupt Practices Act, with respect to auction rate securities, insider trading, and so forth. So I think they have done a great job in many areas.

That said, we are making it very clear now that our goal is to refer to State regulators and to other self-regulatory organizations cases that are not going to have a major investor protection impact so that we can really focus our attention on very high-impact cases done in a much more timely way, because that is really how we protect investors. We shut down Ponzi schemes faster, we end accounting frauds faster, we stop insider-trading rings faster.

So we are trying to shift the focus to larger cases brought more quickly, but I don't think it is entirely fair to suggest that only small matters were brought before.

Mr. ADLER. Thank you, Madam Chairwoman.

I hear you say it is not entirely unfair either, I think, implicitly in your answer.

You had a colloquy a moment ago with the gentlewoman from California regarding personnel and a revolving-door concern. I wonder if, given the fact that Wall Street has something of an unemployment problem right now, you are seeing an upturn in the quality of resumes to look at some of those bigger issues that you are describing the Commission doing such a good job pursuing.

Ms. SCHAPIRO. We absolutely have. And just to give you one small anecdote, we posted several positions, I think four, for risk assessment experts to come and join us, and we got over 500 resumes, some of which had just amazing experience on Wall Street. So we are fully taking advantage of Wall Street's pain.

Mr. ADLER. It is good, from a Commission point of view.

I heard another discussion you had with the gentlewoman from California regarding rating agencies. And I want to make sure I heard what you said, because I think I agree with you, and I want to have you articulate it a second time.

Would you believe, from a personal perspective, Mary Schapiro's perspective, that imposing liability upon rating agencies would be a helpful check in the process of their rating various equities?

Ms. SCHAPIRO. I think it could certainly make a very big difference. And we would obviously want to be careful in crafting it. We want rating agencies to work; we want them to work effectively. And we want them to align their interests with those of investors. They are paid by issuers, but their audience is the investing public. And that is what we need to work on, incentives that will encourage that alignment much more effectively.

Mr. ADLER. I think you would agree with me that the three rating agencies didn't work so effectively in the last year and a half on some of the big failures where the market didn't have the information that rating agencies perhaps could have shared more accurately.

Ms. SCHAPIRO. I would agree, they didn't work perfectly.

Mr. ADLER. Are there other measures, other than what the Commission has already undertaken, that you would recommend that Congress consider, separate from the liability discussion you had with the gentlewoman and with me, that might help perfect markets which, right now, in a rating agencies context, are clearly not perfect?

Ms. SCHAPIRO. I would be happy to provide some additional thoughts on that in writing or in a separate meeting.

As I said, we are looking at the rating shopping issues from two different perspectives because we are very concerned about that. We would like, I think, to move forward with more complete disclosure of the track history of how ratings have performed over time so investors can see basically the quality of ratings and whether they measured up over time or they would upgrade and then downgrade and how those were achieved.

So we are look at some additional disclosure, as well.

Mr. ADLER. I know I would welcome and I believe the subcommittee would very much welcome additional information, additional guidance on that.

Ms. SCHAPIRO. I would be happy to do that.

Mr. ADLER. Thank you. I yield—

Ms. SCHAPIRO. If I could just go back to your question on the enforcement, because I do think it is important for me to say: The Enforcement Division at the SEC is full of people with tremendous energy and desire to bring cases. That is what they are there to do, and they are committed to doing it.

And to the extent the Commission made that difficult for them, they may have focused on some of the less significant cases. But what I have found in my 5 months with just taking a few of the handcuffs off, that they have really stepped up to plate and done a phenomenal job.

And so I don't want anything I said to in any way suggest that these aren't public servants who have been really knocking themselves out over the last 10 years to try to do the best they can for American investors.

Mr. ADLER. I suspect your work just empowered them further. Thank you very much.

Chairman KANJORSKI. Thank you very much.

And now we will hear from the gentleman from Texas, Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

Madam Chair, welcome.

I believe that, in an earlier colloquy with one of my colleagues, you articulated a concern that the proposal to create a CFPA potentially could erode the investor protection mission of the SEC.

I don't want to put words in your mouth. Did you say something along those lines?

Ms. SCHAPIRO. What I said was the transfer of SEC enforcement responsibility to the CFPA would erode the SEC's overall ability to protect investors and to keep our rule-making and policymaking connected to the enforcement arm of the agency, a linkage I think is—

Mr. HENSARLING. And what would be the consequences of that, ultimately, for the investing public, if Congress were to enact legislation that ultimately had that result?

Ms. SCHAPIRO. That took the SEC's enforcement authority away?

Mr. HENSARLING. Yes.

Ms. SCHAPIRO. Well, I think what you would find is that, over time, the rule-making function, which is often informed by enforcement cases, would be damaged.

So, for example, when we bring enforcement cases because we have found problems within a brokerage firm or an investment adviser, the results of that enforcement directly inform the policymakers about whether a new rule is necessary in a particular area. And it works going back the other way.

I think of investor protection as all of a piece. It is enforcement, it is examination, it is rule-making, it is the accounting standards and the disclosure requirements. Those are all part of the fabric of investor protection.

Mr. HENSARLING. I believe you also said, or acknowledged, that you believe there would be some areas of overlap with a potential CFPA. What do you believe those areas of overlap may prove to be, and what are your concerns in that regard?

Ms. SCHAPIRO. I think the possibility—first of all, I should say that, as the legislation is currently drafted, there are actually some definitional issues that I think create concerns.

Mr. HENSARLING. Well, there are several different pieces of legislation floating out there.

Ms. SCHAPIRO. Well, the last one I saw talks about the CFPA will not regulate entities registered with the SEC but have virtually everything else. The concern of that is public companies issue stock. That is very much an SEC-centered function that we bring enforcement actions for. We would not want to see this legislation preclude that, and I don't believe that is what was intended.

But the areas I see where we have a potential are hybrid products. Credit products are intended to be part of the CFPA. There is a possibility for hybrids, I think, to be created. Undoubtedly, as we sit here, a rocket scientist somewhere is devising a product that will fall in an unusual place within the regulatory regime. And so it will require a lot of coordination, I think, to make sure that doesn't happen.

Mr. HENSARLING. With respect to a hybrid product, some type of investment product, isn't it true that an investment product may actually lower risk for one investor, yet the same investment product could increase the risk, depending upon what investment portfolio the investor has, what his investing goals are? Is that not true?

Ms. SCHAPIRO. Sure. I mean, that is why the SEC's rules and customer protection rules are really built on a concept of suitability: that a broker recommending a product must make a determination that product is suitable for that investor.

Mr. HENSARLING. So, again, one product could be helpful to one investor and may prove to be harmful to another investor. That is why many of us have the concern that, under all of the pieces of legislation we have seen with respect to the CFPA, that we have a body that ultimately can proscribe and simply outlaw certain consumer credit products. And so, again, I just make the point that a consumer credit product may be right for one consumer and may be wrong for another consumer.

Let's move on in the very brief time I have to executive compensation. I believe I heard you say in your testimony that it is an area, certainly, the SEC is moving. I know there are at least two broad proposals that are out there. I think we are in the comment period, I believe, on those.

My question is this: Has the SEC undertaken a study to look at the compensation proposals of, say, JPMorgan, Bank of America, Citi? And is there any data that indicates that the compensation structures for those that were hardest hit by the credit crisis were somehow different than the compensation structures of those who navigated the crisis more successfully?

And, with the limited time I have, also with respect to the firms that have returned their CPP money, were they judged to have superior compensation structures than those that didn't return their CPP money as of yet?

Ms. SCHAPIRO. I am not aware of a study undertaken by the SEC.

I do believe that compensation practices can contribute very significantly to risk-taking within a company. But our rules have been designed to get at the maximum clarity and disclosure about how that happened. So we have already, and have had for years under my predecessors, very complete disclosure of compensation and a discussion by the compensation committee about how they arrive at different kinds of compensation programs within the company.

What we are proposing to do now is expand that disclosure, to ask for a discussion by the comp committee about the linkage between compensation programs and risk-taking and also to disclose conflicts of interests of compensation consultants to the board who may also be doing work for management.

Mr. HENSARLING. Thank you.

I see I am out of time.

Chairman KANJORSKI. Thank you very much, Mr. Hensarling.

And now we will hear from Mr. Himes of Connecticut.

Mr. HIMES. Thank you, Mr. Chairman.

I have a couple of questions relating to a specific matter I would like to submit for the record, if that is okay.

Chairman KANJORSKI. Without objection, it is so ordered.

Mr. HIMES. Thank you.

Madam Chairman, thank you for joining us. And I would like to add my voice in praise for the efforts you have taken to date.

I have two maybe paradoxical observations and questions. The first is with respect to investor responsibility. And you are going to hear me say momentarily how important I think it is that we get the regulatory apparatus correct.

But I get concerned, frankly, as we talk about the regulatory apparatus, that we may lose the critical concept of the responsibility that investors have for understanding the risk of the instruments that they employ. As we talk about money market funds, which were never designed to be guaranteed against the breaking of a buck, or about alternative investments like the Bernie Madoff deal, I think it is critical and the system will not work unless people understand that unless their instrument says "guaranteed by the Federal Government," it is not and they can lose it.

And I guess I would just love to hear you say that this is a thought and a concern of the SEC, as well.

Ms. SCHAPIRO. It very much is.

This is a personal view. As a Nation, we don't do a very good job educating, starting with our young people, about investment and why it is important, what the risks are, and what the individual's responsibility really is. And it is something I hope that perhaps this Congress or another Congress will take up in a serious way.

Mr. HIMES. Thank you. I am sorry, but I have very limited time, and I am actually more concerned about question number two, which is: It staggers me, frankly, that the conclusions drawn by this debacle often on the other side of the room are that, because the regulatory apparatus failed, we should just throw the enterprise over the edge.

It is dangerous, and it is ahistorical. The history of the last 120 years in this country has been of a gradual development of a regulatory apparatus that has protected American families—120 years ago, Americans ate rotten fruit, they burned to death in shirt factories that were not regulated, they bought securities that would make Madoff look easy, they bought snake oil. For 120 years, we have evolved a regulatory apparatus that has dramatically increased the quality of life and the safety of the American citizenry.

And the conclusion, therefore, that because we did it wrong—and, boy, did we do it wrong in the last 4 or 5 years—that we should just throw the enterprise away and leave everything to individual responsibility is dangerous and ahistorical.

We have talked a lot today about the rules and the changes that have been proposed, but we haven't talked enough about the topic that I would love to devote the rest of my time to hearing you talk about, which is the culture of your agency.

We can get the rules right and everything else absolutely right, but unless the SEC has an entrepreneurial culture, where people feel like they can take some risk, where they can raise their hand if they think that something is wrong, where they think that they are adequately compensated for doing their job well, we are going to fail.

So I guess I would love to, just in whatever remaining time I have left, hear you talk about what your vision is for the culture, the compensation of the SEC and its people.

Ms. SCHAPIRO. It is a great question, and it is absolutely fundamental to our being able to do any of the things that we have laid out as being important.

And I would agree with you that writing rules is great and bringing enforcement cases is great and necessary and getting the structure right is necessary, but we have to be able to tap into a deep well of energy and enthusiasm on the part of our people in order to make any of that happen.

And I have to say, in my 5 months, I have been stunned by the willingness of people, after a pretty long period of not raising their hands and not taking risks, I have been stunned by their willingness to do just that now.

And some of the cases I mentioned in my opening statement, those are cutting-edge cases for the SEC. The willingness of people to come up with new ways to approach problems like Madoff, it gives us a list of actions that we have been able to take very quickly to try to respond. It didn't prevent Madoff, but hopefully going forward it helps us to prevent the next one.

Those things are all important. And my experience, as having been in and out of government my entire career, is that if you entrust people with the ability to make those decisions and do what they came to government to do, the results will be pretty good. And I will tell you, in my 5 months, that is exactly what I have seen at the SEC.

Mr. GARRETT. I see the gentleman has time, but will the gentleman yield?

Mr. HIMES. I will yield.

Mr. GARRETT. If the gentleman would please supply the committee with which Members on either side of the aisle has called for the entire scrapping of the entire system, I would be curious. I think I have heard from both sides of the aisle. Over here, Mr. Ackerman saying that Members from his constituency having problems with the system. I have met people from our side of the aisle saying they have problems with the system and that we are trying to get the right regulation. But if he has heard anyone say that they want to scrap the entire system and go back to absolutely no regulation, I would appreciate hearing from you, because I have never heard that.

And I yield back.

Mr. HIMES. Thank you.

Mr. Chairman, I yield back the balance of my time.

Chairman KANJORSKI. Thank you very much.

And now we will hear from the gentleman from Florida, Mr. Putnam.

Mr. PUTNAM. Thank you, Mr. Chairman. I don't think I was next in line.

I think the gentleman from California beat me here.

Chairman KANJORSKI. Oh, he did? Well, we will withdraw your recognition, and we will hear from the gentleman from California for 5 minutes.

Mr. MILLER OF CALIFORNIA. Well, thank you very much.

Welcome, Madam Chairman.

It was probably February last year I introduced an amendment to one of the housing bills, and it required the SEC and the Feds basically to look at the mark-to-market issue and consider suspending mark-to-market or modifying it in some fashion.

And it was funny, back then, many people you talked to, when you mentioned mark-to-market, they kind of looked at you like a deer in the headlights, like, what are you talking about? I know Chairman Frank understood the issue, and the committee accepted it on a voice vote. And I think it took me three more times putting it in bills, and every time we would put it in the bills, the Senate would pull it out of a bill and not recognize the situations we are going through today.

And, according to the Feds, they give investors up to 90 percent of asset current market value today, and then the Feds hold that asset and collateral in a non-mark-to-market account. Is that correct?

Ms. SCHAPIRO. I am sorry; I don't know the answer to that.

Mr. MILLER OF CALIFORNIA. Okay. Have you been very involved in the mark-to-market issue?

Ms. SCHAPIRO. Well, I have been involved in the mark-to-market issue from the perspective of FASB and the SEC's oversight of FASB. And the SEC produced a report last year on fair value of mark-to-market accounting, which led to FASB's April guidance that was issued, with respect to how companies should value assets for fair market purposes, meaning that it is the price that you would get for an asset sold in an orderly market as opposed to having to go with a fire sale price.

Mr. MILLER OF CALIFORNIA. Okay. Under the terms and conditions of the Taft program, it states, "Taft loans will not to subject to mark-to-market or remargining requirements." Is that correct?

Ms. SCHAPIRO. I assume so. I am sorry, I just don't know. I would be happy to provide information—

Mr. MILLER OF CALIFORNIA. Having been involved in the real estate industry for well over 35 years, you could see the problems that lenders were facing with the mark-to-market concept, especially in a declining market when you could not go out and determine the value of an asset because there was no market for the asset. Lenders not only made the loan, they were setting up huge reserves for prospective losses or, in some cases, losses they were taking on current foreclosures. It created a situation where the market basically became illiquid.

It is an interesting marketplace we are facing today with banks. It seems like the Feds have put a lot of money in the banking industry today, and the banks are sitting on money. But the anomaly of that is they are not making loans, and for the average citizen who has money they want to put in a savings account, banks don't want the money.

And so we have created an unusual situation that I think is having a dramatic impact on the marketplace. And if you look at how the mark-to-market has really had a negative impact on the banks today as it applies to residential loans, I think you see the same problem coming in the near future in commercial/industrial loans.

Are you current on the situation that the market is facing with those two areas?

Ms. SCHAPIRO. Very generally.

Mr. MILLER OF CALIFORNIA. We have experienced a huge decline in the residential marketplace in the last 2 or 3 years. Probably by the fourth quarter of this year—and I have been saying it for about 6 months now—you are going to see a huge foreclosure hit on the commercial/industrial sector. But the problem with that is the bottom to that trough is probably not going to hit for 3 years.

So we have a situation now where banks are not lending, they are not wanting loans because they have so many funds from the Federal Government they are holding, and they are going to be taking huge hits again on the commercial/industrial sector.

How are the revisions in the mark-to-market going to impact them or benefit them in the future?

Ms. SCHAPIRO. Well, I think the way that—they are really two areas. One is the fair value guidance that was issued by FASB that makes it clear they do not have to price assets at fire sale prices, that they can use prices that would be received in an orderly market. And the second is with respect to other than temporarily impair, which allows the banks to recognize fair value declines that result from volatility, interest rates, liquidity, to include those in other comprehensive income and not have to include them in any—

Mr. MILLER. But how do the regulators apply this to the holdings of the banks at that point in time?

Ms. SCHAPIRO. I don't know how the bank regulators would apply the accounting rules or use them with respect to their capital requirements.

Mr. MILLER OF CALIFORNIA. But don't you think that is germane to what we are trying to deal with there? Or it is going to be significant. If you have two agencies looking at it from a different perspective, you trying to resolve the mark-to-market issue in some limited fashion and the regulators are looking at it from a different perspective, don't you think we need to do something to get those two together?

Ms. SCHAPIRO. Well, we do talk with the bank regulators on these issues, and FASB has a very open door and an open line of communication with the bank regulators on all these issues. So for example, when the banks were going through their stress tests they were utilizing information provided by FASB about what might be expected in the future, for example, with respect to off balance sheet accounting so that those tests could be more comprehensive. So there is quite close communication.

Mr. MILLER OF CALIFORNIA. I think Ranking Member Bachus and Chairman Frank have a bill that they are putting on suspension, it should be next week. And the banks are in a difficult situation. They are having to take homes back, and then the regulators are basically forcing them to put those homes in the marketplace because of mark-to-market and liquidity and they are sitting aside because they are nonperforming assets at that point in time. And basically what the bill does is it says that a lender can have up to 5 years that they can put the unit on the market as a rental, thereby getting it off the declining asset again, performing asset market, which would change the mark-to-market value of it. Because in California, like San Bernardino County—they are part of this—probably 78 percent of the homes in the marketplace are distressed sales from lenders. L.A. County is like 56 percent. Even Orange County, which is a very good market, is about 43 percent. And dealing with the same situation of trying to give them some relief because the regulators are forcing the banks to put these units out there instead of holding them because banks are really not in the real estate business by law, but this gives them a 5-year window to try to deal with it.

But I think the concern I have is that the regulators and you might not be on the same page on this.

Ms. SCHAPIRO. Well, I can tell you, as I said, we have regular communication with the bank regulators with respect to accounting issues. And I think they have obviously great flexibility in the application of their capital requirements for banks, greater flexibility than we have—

Mr. MILLER OF CALIFORNIA. I hope they demonstrate their flexibility in working through these difficult times.

Ms. SCHAPIRO. I am sorry?

Mr. MILLER OF CALIFORNIA. I hope they demonstrate their flexibility in working through these difficult times. And I thank you for your patience, Mr. Chairman. I yield back.

Chairman KANJORSKI. Thank you, Mr. Miller. And now we will hear from the gentleman from Michigan, Mr. Peters.

Mr. PETERS. Thank you, Mr. Chairman. Thank you, Chairman Schapiro, as well for your testimony here today. And I would like to join others in applauding your efforts and appreciate several of your comments.

One of your comments that I found particularly welcome was that everything at the SEC now is related to investor protection, and I appreciate that statement. And I believe it has also been consistent with your record, particularly as head of FINRA. I had the opportunity to be an arbitrator for a number of years at FINRA and know that under your tenure that organization continued to strive for excellence in protecting investors. And in follow-up to my colleague here, Mr. Himes, about investor education, I also had an opportunity to be part of an investor seminar that FINRA hosted in my district not too long ago to really work to make sure that investors understood the risk related to investments and to make sound investment decisions. And I know that occurred under your tenure so I appreciate your efforts.

I also appreciated your comments to a question that at the end of the day it is the shareholders who are the owners of these companies. And in a capitalistic system of course it is fundamental to capitalism that the owners have the ability to exercise the authority that they have because of their ownership interest of those organizations.

So my question is related to a speech that was given before the Society of Corporate Secretaries and Governance Professionals last month by Commissioner Walter. She discussed the SEC's efforts to enact new rules to empower investors in that speech. She specifically discussed proposed rules to give shareholders access to management proxy materials for the purposes of board elections, an SEC-approved rule on unrestricted broker voting, and improved disclosure of executive compensation and corporate governance. And in that speech she stated that, "legislation that reaffirms our authority would remove the distraction of challenges to authority that Congress had previously granted to the SEC."

Do you also believe that it would be helpful for Congress to provide specific statutory authority to the SEC as it undertakes what I believe are very important reforms?

Ms. SCHAPIRO. I do believe it would be helpful. The agency has gone down these paths before and frequently been challenged in court over these issues. And we may well be challenged this time around, particularly with respect to proxy access.

So while we have gone ahead and done proposed rules that we believe make sense, it would certainly not be harmful in any way to have backstop statutory authority.

Mr. PETERS. And in follow-up, are there other reform measures with respect to corporate governance that you feel may be important but would also explicitly require some statutory authority on our part to assist you in these efforts? Maybe you can answer broadly as to where you think we should be going, but also where Congress can be helpful to you in those efforts.

Ms. SCHAPIRO. Well, I think we are very focused right now on the issues. We have outstanding access to the proxy, the additional proxy disclosure requirements that we have gone forward with. We will be looking later this year at disclosures related to environmental issues as those become very, very prominent topics of public policy and enormous costs for public companies as they seek to meet different standards under environmental legislation. We will be looking at those issues. Again, those are disclosure related, so I don't think they will require legislation. I know that Congress has talked from time to time about whether there ought to be say-on-pay legislation. The SEC has gone forward with rules that were required under the Economic Stabilization Act to require say-on-pay advisory votes for companies that are recipients of TARP funding, and it would be a question whether say-on-pay should be extended more broadly to other public companies although many of those advisory votes are being done now pursuant to shareholder proposals.

Mr. PETERS. Thank you. Mr. Chairman, I yield back.

Chairman KANJORSKI. Thank you very much, Mr. Peters. And now we will hear from the gentleman from Florida, Mr. Putnam. If you start talking very quickly, that is it.

Mr. PUTNAM. Thank you, Mr. Chairman. And I want to thank the Chairlady. Let me begin with short sales. Your predecessor suspended them in the beginning of the economic crisis. He later stated that he regretted having done so and that the costs outweighed the benefits.

What is your take on that?

Ms. SCHAPIRO. Yes, Chairman Cox did make the statement that it was one of the worst mistakes that he felt that they had made. And I will say that what the agency did last fall was done in a series of very quickly implemented emergency measures of different sorts; banning short selling, along with a number of other things. As we have reexamined short selling, we have determined not to do it in any kind of an emergency context but rather to do it in a very thoughtful deliberative rulemaking process. So we published several months ago two different approaches to not banning short selling but restricting short selling.

One would essentially bring back a marketwide uptick rule that would require that you could only short sell when the last prior transaction was implemented on an uptick or an up bid. The other is a very focused rule that would apply to individual stocks but not across the whole market where if a stock declined by say 10 percent in a day there might be a short selling restriction for some period of time thereafter.

The comment period on those proposals closed on June 19th. We have close to 4,000 comment letters that we are working our way through. We also held a roundtable where we brought lots of experts, investors, financial services firms, exchanges and others in to talk about the impact on the markets of short selling rules and the impact on investor confidence. We are factoring all of that into our process and our thinking and we have come to no conclusions yet about whether or not to go forward.

Mr. PUTNAM. Let me jump ahead to money markets. One of the most telling signs that we were in a noncyclical economic crisis last fall was when a money market broke the buck and another closed just before breaking the buck. Your new rules—first of all, the additional government protection that has been placed in the money market funds world, will that in your view cause greater risk taking among the money market pool of funds?

Ms. SCHAPIRO. Well, that cover guarantee program, I believe, expires in a couple of months. So what we have actually seen, though, is given the events of the Reserve Fund breaking the buck, money market funds actually tightened up on their quality and liquidity and maturity standard. So they went to higher quality, not lower quality, despite the presence of the guarantee fund. And I don't know that the Fed and the Treasury have come to any conclusion yet on whether or not to extend that.

Our proposed rules are geared towards really bolstering the resiliency of money market funds going forward, so they are higher quality standards. We also propose that money market fund boards of directors be able to suspend redemptions when a fund breaks the buck as the Reserve Fund did so that all shareholders will get equal treatment in the distribution of assets rather than those who are just quick to the draw getting in first when the fund has broken a buck and getting a higher payout. And we have also asked for comments on whether money market funds should move away from the $1 stable net asset value to a floating net asset value that might cut down on the chances for a run on money market funds.

Mr. PUTNAM. And finally, the regulatory reform bill package that is being discussed, it is my understanding does not include GSE reform.

Ms. SCHAPIRO. No, that is right. I believe the decision of the Administration was to engage in further study with respect to the GSEs and come back to that issue later this year.

Mr. PUTNAM. Is it your view that these entities which hold up to 50 percent of the mortgages in the country would need to be part of a regulatory overhaul?

Ms. SCHAPIRO. I think at some point we as a government are going to need to address the future of the GSEs, yes.

Mr. PUTNAM. Thank you. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Putnam. Now we have a request for a second round. I have passed, and Mr. Garrett has passed, but we recognize the ranking member of the full committee, Mr. Bachus, for 5 minutes.

Mr. BACHUS. Thank you, Mr. Chairman. Recently FASB announced some changes in the securitization accounting rules. The Federal Reserve and other bank regulators have cautioned that the rule changes threaten the viability of the Federal Government's economic recovery plan because that plan is partially dependent on restarting the securitization markets. And there has been some comment and concern that the accounting changes would actually throw into question the securitization model that we have been using in the past.

Are you concerned about the timing of the scope of their accounting rule changes, particularly given the emphasis that the government and I think private economists have in restarting the securitization market?

Ms. SCHAPIRO. I should say as a prelude to that, that the SEC is very interested in doing what we can to help assure a vibrant asset-backed securities market. And we have made a number of proposals that would require legislation that would allow for a more continuous disclosure, and so forth, for asset-backed securities. I think what FASB has done with respect to off balance sheet is really very important. There has been a conclusion or at least a view widely expressed, frankly, by governments around the world that off balance sheet accounting is a contributor to the financial crisis.

And so FASB and other accounting standard setters have worked very hard to eliminate the exception that allowed a company to remove financial assets from their balance sheet when they transferred them to a special purpose entity even though they retained an interest in the loans—in the cash flow from the loans. And I think it was a very important gap for them to close.

I recognize, and maybe there is never a good time for new accounting standards to be put in place from the perspective particularly of regulated entities, but I think it was a very important gap that needed to be closed. It goes into effect at the end of the year, and obviously we will watch it very closely.

Mr. BACHUS. Now, you are aware that the bank regulators and the Federal Reserve has expressed some real concerns about it.

Ms. SCHAPIRO. Well, I haven't heard that they had recently expressed real concerns about it, although it doesn't completely surprise me. We will certainly have conversations with them.

Mr. BACHUS. And when you do, when you talk to them could you maybe, if you maybe respond in writing as to whether you think that if they still have those concerns, if there is merit.

Ms. SCHAPIRO. I would be happy to.

Mr. BACHUS. Okay. Thank you. You know, for the first time in the SEC's history, your budget is likely to cross the $1 billion mark. And with all the current responsibilities you have and the likelihood that you are going to have a greatly increased number of entities subject to your Commission oversight, you know, that is not surprising.

Do you think that the Commission can leverage the expertise of the existing and potentially new self-regulatory organizations to supplement its work? How do you perceive it?

Ms. SCHAPIRO. Well, my bias is I come from a self-regulatory organization where I spent 13 years. And so I think self-regulatory organizations with close oversight from the Federal Government, from the SEC in the case of FINRA or the New York Stock Exchange or the Nasdaq Stock Market, with close oversight can bring tremendous value to the protection of investors, and in the case of exchanges the assurance of market integrity.

So it is an area that we are willing to explore, because even though our budget is growing we are likely to never have all the resources we need to do everything we would like to do. And the extent to which we can leverage SROs, accounting firms, other whistleblowers, I am game to do that because I think it will allow us to do a better job.

Mr. BACHUS. And to focus on the Bernie Madoffs of the world. Any specific ideas on where you might go with that?

Ms. SCHAPIRO. Well, we have engaged in quite a lot of work to try to be very responsive to the Madoff tragedy.

Mr. BACHUS. No, I didn't mean the Madoff. I meant the private, the self-regulator.

Ms. SCHAPIRO. Again, I think the key to the success of self-regulation is really vigilant oversight by the SEC, and it is something that we don't have a self-regulatory organization, for example, with respect to investment advisers. We have not opined as an agency about whether that would be an appropriate thing for us to do. But I think given our resources, we need to consider every opportunity to leverage third parties.

Mr. BACHUS. Could I have one more question, Mr. Chairman?

You know, for almost 30 years we have had a financial products regulatory structure which is divided into two categories, securities and futures, where you had two different regulators, and I know there has been a lot of discussion about where to go. I am not going to ask you whether you think we ought to merge the CFTC and the SEC. I don't think you probably want to volunteer your opinion on that, but if you do you are welcome to. I know we are the only nation that still has separate regulators. But given that there is a unique situation which does present some regulatory challenges, do you—and you are supposed to prepare, you and the CFTC are supposed to prepare a report to harmonize the offering rules, the regulations, and the regulatory approaches on securities and futures. What are some of the challenges facing you with this September 30th date coming up and do you think you are going to be able to do it by the 30th? And I will throw in, and do you think there ought to be one regulator? But you don't have to—

Ms. SCHAPIRO. I have said that I believe there is a logic and efficiency to merging the two agencies. I think we have overlapping authorities, we have some arbitrary lines that have been drawn between the agencies over many years, and I absolutely understand the origins of all that. There would be a logic and an efficiency. But if we are not going to do that then it really does behoove the two agencies to work together as effectively as we possibly can. And we are both, Chairman Gensler and I, very committed to doing that.

As you point out, we have been charged with creating a report on harmonization initiatives by September. We are well into working through that and trying to identify those areas where the agencies have different rules and requirements. It is challenging in part because we also have very different approaches to regulations and we grew up under very different circumstances. CFTC largely regulates an institutional market with a vertically integrated exchange and clearing structure. We regulate largely retail markets with multiple exchanges and clearinghouses that are not vertically integrated. And just those two perspectives alone make this a challenge, but we are working in good faith to get as far as we can in this process of identifying the areas of difference.

Mr. BACHUS. And if you can't make that deadline of course you will ask for a—will you put—do you anticipate putting out some agreement and then working towards other areas of harmonization?

Ms. SCHAPIRO. We haven't really talked through what we would do if we don't make it on the theory that we have to put the pressure on our staffs to see if we can make it, but my guess is we would put out some kind of interim statement at least about our progress.

Mr. BACHUS. All right. Thank you very much. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Bachus.

The Chair notes that some members may have additional questions for this witness which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to this witness and to place her responses in the record.

I will just take a moment. We normally dismiss the panel, but thank you very much, Chairman Schapiro, for I think really being forthcoming to the committee since your entry into this position and working with us over the last 5½ months in a very positive way. We look forward to a continuation of that progress and want to thank you for being here. We thought we would have you out before noon but it is pretty close, and for government time that is very good.

Ms. SCHAPIRO. Thank you very much.

Chairman KANJORSKI. Thank you. The panel is dismissed, and this hearing is adjourned.

[Whereupon, at 12:25 p.m., the hearing was adjourned.]

A P P E N D I X

July 14, 2009

OPENING STATEMENT OF CHAIRMAN PAUL E. KANJORSKI
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES
HEARING ON SEC OVERSIGHT: CURRENT STATE AND AGENDA
JULY 14, 2009

We meet today to focus on the work of the U.S. Securities and Exchange Commission. Although she is no stranger to us, this hearing also represents the first time that Mary Schapiro will testify in her new capacity as the head of the Commission.

Chairman Schapiro has, of course, taken over the helm of a much beleaguered agency. In recent months, many have criticized the Commission for its lack of diligent enforcement. The Commission showed particular ineffectiveness when, despite numerous warnings, it failed to uncover the Madoff scandal. This $65 billion fraud has caused extreme hardship, if not ruin, for far too many individuals, pension funds and charitable institutions.

Our panel has already examined the Madoff affair in great detail, using the unfortunate episode as a case study to examine the gaps in our existing regulatory structure and to identify solutions to fill these holes. The recent public assessments of Harry Markopolos and the Government Accountability Office show an agency in distress. To restore investor confidence in our markets, the Commission must expeditiously change the way that it does business.

Since her return to the Commission as Chairman, Mary Schapiro has moved aggressively to focus the agency on fulfilling its key mission -- protecting investors. She has beefed up the importance of the enforcement unit, pursued significantly more enforcement actions than her immediate predecessor, and removed unnecessary hurdles that slowed progress in enforcement cases. In less than 6 months, she has also replaced nearly all of the agency's senior officials.

In nominating Mary Schapiro, President Obama remarked, "Mary is known as a regulator who's both smart and tough -- so much so that she's been criticized by the same industry insiders who we need to get tough on...I know that Mary will provide the new ideas, new reforms, and new spirit of accountability that the SEC desperately needs so that fraud like the Madoff scandal doesn't happen again."

Without question, I wholeheartedly concur with the President's assessment. In her short tenure, Chairman Schapiro has displayed a commitment to implementing the reforms needed to change the internal culture and external perceptions of the Commission.

The Commission, however, must continue to take bold and assertive action as it moves forward to bring enforcement actions against wrongdoers and to rewrite the rules governing the industry to better protect investors. Without further action to finalize regulatory proposals on proxy access, the custody of client assets, and short sale restrictions, investors will lack the real protections that they need. The hard work on these matters therefore lies ahead.

As the Commission works to put in place new rules, Congress must also work to update our securities laws. In this regard, Chairman Schapiro has recently transmitted an ambitious set of 42 legislative proposals. The Commission's Inspector General has also offered us some ideas.

And the Obama Administration has, of course, already relayed general concepts and specific legislative proposals. I am now developing a bill based on these useful recommendations.

Of the many suggestions already proposed, one important one stands out: We ought to put in place new standards that reward whistleblowers when their tips lead to catching fraudsters. By encouraging whistleblowers to come forward when they know of wrongdoing, we will leverage the Commission's limited resources and increase the number of cops on the beat.

Improving the Commission's overall operation and performance will additionally require a significant increase in its budget. Chairman Schapiro has noted that the agency lacks the resources required to match increasingly sophisticated markets. Fortunately, the House will soon consider a bill providing for a modest increase of 8 percent in the Commission's 2010 budget.

But, we must do even more to remedy these constraints. The financial crisis shows what happens when unbridled capitalism lacks a strong regulatory check. We must therefore seriously consider the Commission's request to raise its 2011 budget authorization by an additional 20 percent.

Alternatively, we might decide to put the Commission on the same independent footing as other financial regulators by moving the agency outside of the appropriations process.

In closing, I look forward to Chairman Schapiro's testimony today. Her comments will help us as we embark on overhauling financial services regulation.

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EMBARGOED UNTIL DELIVERY
Tuesday, July 14, 2009

Contact: Erica Elliott
Phone: 202-744-2693

Garrett Opening Statement for Financial Services SEC Oversight Hearing

(Washington, DC)– **Rep. Scott Garrett (R-NJ) released the following opening statement for today's House Financial Services Subcommittee on Capital Markets hearing entitled "SEC Oversight: Current State and Agenda":**

"Thank you Chairman Kanjorski and welcome to Chairman Schapiro. Thanks again for the opportunity to chat with you Friday in anticipation of this hearing, which is your first chance to speak before this subcommittee on your regulatory agenda.

"There are so many fronts on which the SEC is actively engaged at the moment, it's a little daunting to know where to start. You certainly have your hands full as a new Chairman of an agency that I think it's fair to say is under a lot of scrutiny for events that have taken place under its watch over the last few years.

"One place to start is with the SEC's budget. In the House Financial Services Appropriations bill recently passed out of Committee, for the first time ever, the SEC would be funded at more than $1 billion. In a recent letter I received from a group of Bernard Madoff's victims, they ask why, given the SEC's recent investor protection and enforcement track record, is Congress seriously considering giving the SEC more money and authority to regulate the financial services industry. I think similar questions are on a lot of people's minds, and look forward to you addressing this issue.

"As for specific policy areas on the SEC's plate, one area where I've become increasingly engaged, and I know the SEC has, as well, is in the area of regulatory proposals for Over-the-Counter derivatives. As I have said a number of times previously, 94% of the 500 largest global companies use derivatives to manage risk. Policymakers, therefore, need to tread very carefully as we look at regulatory options for these markets. Over-regulation or improper regulation that might sound good politically could have major unintended negative consequences, not just for our financial markets, but for our broader economy.

"It is my understanding that the SEC and the CFTC, along with the Administration, have been engaged in discussions over OTC derivative regulation, including discussions regarding which agency should have jurisdiction over particular pieces of these markets. I will be interested to hear from Chairman Schapiro about particular areas of disagreement the SEC has with the CFTC on derivatives regulation. I am also interested to hear if there are areas of current CFTC jurisdiction where the Chairman feels the SEC is better suited to regulate.

"On another front, the Administration late last week released draft legislation seeking to establish consistent standards for broker-dealers and investment advisors that would also give the SEC the power to ban certain forms of compensation that are "not in the investors' best interest." This comes on the heels of the Democrats' proposal for the so-called "consumer financial protection agency". Both proposals reflect a government-knows best mentality that will likely restrict consumer choice and be embraced by trial lawyers for all the unnecessary litigation they will spawn. I will be interested to hear from the Chairman regarding the SEC's input on these proposals and to what extent she is comfortable dictating how a firm should compensate its employees.

"As I mentioned at the beginning of my statement, there are a whole host of other issues the SEC is currently examining, as well. I will be interested to hear an update on the SEC's proposed rules to restrict short selling, as well as the Chairman's thoughts on different ideas to reform credit rating agencies, which I know is an area that Chairman Kanjorski and others are interested in pursuing legislatively and may be one area of reform where some bipartisan consensus can be reached.

"Again, welcome Chairman Schapiro. I look forward to your answers to questions I have and an interesting and lively dialogue today amongst you and my colleagues on the subcommittee."

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Testimony Before the
United States House of Representatives Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises

"SEC Oversight: Current State and Agenda"
Tuesday, July 14, 2009
by
Chairman Mary L. Schapiro
U.S. Securities and Exchange Commission

Chairman Kanjorski, Ranking Member Garrett, and members of the Subcommittee:

Thank you for the opportunity to testify today on behalf of the Securities and Exchange Commission. I sincerely appreciate the support this Subcommittee has shown the SEC, and I am pleased to have the opportunity to discuss the Commission's role in helping to address the financial crisis, and to outline the steps we are taking to improve investor protection and restore confidence in our markets.

Overview

The last year has been a wrenching time for investors. Trillions of dollars in wealth have been destroyed during the economic downturn, and millions of Americans have seen their retirement nest eggs and college tuition funds shrink dramatically as a result. The economic crisis has challenged the faith of many in our system of capital formation and allocation – a system for creating wealth that has proved over the long term to be the greatest the world has seen.

As the agency charged with protecting investors, maintaining fair, orderly and efficient markets, and facilitating capital formation, we are dedicated to learning from recent events and making the changes necessary to help restore market integrity and investor confidence. The SEC must act promptly, decisively, and with resolve. We also must redouble our commitment to protecting investors, as they provide the capital used to fund the productive enterprises that create jobs and wealth.

To that end, we have begun implementing many changes at the agency that will reinforce our focus on investor protection and market integrity. Indeed, there is an invigorating sense of urgency at the Commission to make sure we are rapidly implementing changes designed to protect investors and promote investor confidence.

We are:

- working to fill regulatory gaps exposed by the economic crisis;
- seeking to strengthen standards governing broker-dealers and investment advisers;
- enhancing disclosure provided to investors;
- streamlining enforcement procedures and focusing on cases that will have the greatest impact;

- revamping the system for handling the approximately one million tips and complaints we receive annually;
- improving our risk assessment capabilities;
- bolstering our internal training; and
- bringing on new leadership and new skill sets throughout the agency.

While we can never stop every scam artist scheming to defraud investors, I believe these and other changes will greatly improve our odds of catching them. Indeed, in the wake of the Madoff fraud, I believe we owe it to investors to show them that we can and will adapt our ways and learn from our past errors so that we do not repeat them.

The Madoff fraud is one that the agency did not detect, and not a day goes by that we don't regret it. As you know, former Chairman Cox asked the SEC Inspector General to look into what happened and what failed to happen, and to report back to the Commission. We expect to receive the IG report within the next six weeks. Nonetheless, I felt strongly that we could not wait for the conclusion of the Inspector General's investigation to begin making significant changes in response to the Madoff fraud. That is why we are implementing many of the measures I will outline today.

Reinvigorating SEC Enforcement

Enforcement is one of our core competencies and a central part of our heritage as an agency.

During my first few weeks as Chairman, I told our enforcement staff that I believed we could work together to reinvigorate the Enforcement Division, and that a critical self-evaluation would reveal ways in which we could more effectively protect investors.

Penalty Pilot Program & Formal Orders

Almost immediately after becoming Chairman, we ended the two-year "penalty pilot" program. That program had required the Enforcement staff to obtain majority Commission approval before the staff could even begin negotiating penalties against public company defendants. At a time when the SEC needs to send a swift, clear message that corporate wrongdoing will not be tolerated, and penalties for securities violations will be stiff, the penalty pilot program was an unnecessary hurdle to more active enforcement.

Another change we implemented to bolster the SEC's Enforcement program was to provide for more rapid approval of formal orders of investigation, which grant SEC staff subpoena power to compel witness testimony and the production of documents. In investigations that require the use of subpoena power, time is of the essence, and delay can be costly to an investigation. To ensure that subpoena power is available to the staff when needed, the agency has returned to a policy of expedited consideration of most formal orders by a single Commissioner acting as duty officer. The number of formal orders issued from January to the end of June this year is 224, compared with 93 over the same period last year. We are continuing to consider additional measures to further streamline these processes and allow investigations to proceed more expeditiously.

Organizational Restructuring

In addition, we hired as a new Enforcement Director Robert Khuzami, a longtime federal prosecutor who served as Chief of the Southern District of New York's Securities and Commodities Fraud Task Force. We charged Rob with focusing our enforcement efforts on bringing meaningful, high impact cases quickly.

As part of that process, Rob is completing an extensive effort to evaluate Enforcement processes to improve the way the Division operates. In the near future, we will announce several broad reforms, including removing a layer of management to reduce bureaucracy and speed up the enforcement process; improving training for our line law enforcement personnel; fostering increased dialogue among enforcement personnel; streamlining internal processes to make investigative procedures more efficient, and harnessing technology for better risk assessment and operational efficiency. These changes will help us maximize our resources to combat fraud and other wrongdoing in our markets.

Vigorous Enforcement

Meanwhile, our Division of Enforcement has been working diligently. Since the end of January:

- We have filed actions seeking at least 42 emergency temporary restraining orders. During roughly the same period last year, we filed 16.
- We have opened more than 439 investigations. During roughly the same period last year, we opened 395.
- As noted above, the Commission has issued at least 224 formal orders. During roughly the same period last year, the Commission issued 93.

Since January we also have brought a number of strategically important and complex cases, of which I will highlight just a few.

In May, we charged certain operators of the Reserve Primary Fund with fraud for failing to provide key material facts to investors and trustees about the Fund's vulnerability as Lehman Brothers Holding, Inc. sought bankruptcy protection. Last fall, shortly after the alleged violation, the net asset value of the $62 billion money market fund "broke the buck" by falling below $1.00. As part of our enforcement action, we are seeking to bring about an expedited, efficient, and equitable pro-rata distribution to shareholders of the Fund's remaining assets, including $3.5 billion originally set aside in the Fund's litigation reserve.[1] We believe this will help Reserve Fund investors recover a larger share of their assets more quickly.

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1 *See SEC v. Reserve Management Company, Inc., et al.*, Lit. Rel. No. 21025 (May 5, 2009).

In March, we initiated a case alleging fraud in connection with a kickback scheme involving New York's largest pension fund. We charged New York's former Deputy Comptroller and a top political advisor with extracting kickbacks from investment management firms seeking to manage the assets of the New York State Common Retirement Fund. Since March, we have amended the complaint to add additional defendants, including a former New York state political party leader, a former hedge fund manager, a Dallas-based investment management firm and one of its founding principals, and a Los Angeles-based "finder."[2]

In May, we brought the first-ever hedge fund insider trading case involving credit default swaps ("CDS"). In that case, the Commission charged a former portfolio manager at a large hedge fund investment adviser and a salesman at a large investment bank with insider trading in credit default swaps of VNU N.V., an international holding company that owns Nielsen Media and other media businesses. The complaint alleges that the portfolio manager learned information from the investment bank salesman about a change to a proposed VNU bond offering that was expected to increase the price of the CDS on VNU bonds. The investment bank was the lead underwriter for a proposed bond offering by VNU. According to the our complaint, the salesman illegally tipped the hedge fund portfolio manager about the contemplated change to the bond structure who then purchased CDS on VNU for one of the adviser's hedge funds. When news of the restructured bond offering became public in late July 2006, the price of VNU CDS substantially increased, and the portfolio manager closed the fund's VNU CDS position at a profit of approximately $1.2 million.[3]

In June, we charged former Countrywide Financial CEO Angelo Mozilo and two other former Countrywide executives with securities fraud for deliberately misleading investors about the significant credit risks being taken in efforts to build and maintain the company's market share. Mozilo was additionally charged with insider trading for selling his Countrywide stock based on non-public information for nearly $140 million in profits. This subprime mortgage case is part of the Enforcement Division's efforts to pursue cases at the root of the financial crisis.

We continue to bring cases across the spectrum of securities fraud. For example, within the past two weeks we sued the former Chief Accounting Officer of Beazer Homes for accounting fraud[4] and brought an emergency action and asset freeze in a $485 million nationwide ponzi scheme.[5]

Last month, we also expanded our case involving one of the largest ponzi schemes in history – the fraud perpetrated by Allen Stanford and others involved with the Stanford Financial Group. Many of you have reached out to the agency because this fraud touched so many hard working Americans. Now that we have sued Leroy King, the former head of Antigua's Financial Services Regulatory Commission whom we allege Stanford bribed to help him conceal his fraud and thwart the SEC's investigation, the public can truly see the tools Mr. Stanford had at his disposal to perpetrate his crimes. By structuring his fraud around foreign CDs issued from a

[2] *See SEC v. Henry Morris, et al.*, Lit. Rel. No. 20963 (March 19, 2009), Lit. Rel. No. 21001 (April 15, 2009), Lit. Rel. No. 21018 (April 30, 2009); Lit. Rel. No. 21036 (May 12, 2009).

[3] *See SEC v. Jon-Paul Rorech, et. al.*, Lit. Rel. No. 21023 (May 5, 2009).

[4] *See SEC v. Michael T. Rand*, Lit. Rel. No. 21114 (July 1, 2009).

[5] *See SEC v. Provident Royalties , LLC, et. al.*, Lit. Rel. No. 21118 (July 7, 2009).

foreign bank with the local regulator in his pocket, Stanford managed to keep his fraud alive for years despite active efforts to pursue him. Ultimately, working in close coordination with the Justice Department, the SEC was able to marshal sufficient evidence to sue Stanford and his affiliates and begin to identify assets for the benefit of investors. Since we brought our case against him, the Commission staff has continued its investigation, working closely with the Court-appointed receiver and examiner, in an effort to help investors get frozen assets released and to locate additional assets. We will continue these efforts with the goal of returning as much money to investors as we possibly can.

In addition, we are committed to holding responsible and recoup ill-gotten gains from those involved in the Madoff fraud. On June 22, 2009, the Commission filed two additional Madoff-related actions in federal district court in New York against an entity and individuals who received millions of dollars in fees from Madoff for bringing billions of dollars of investor funds into his scheme. In the first action, the Commission charged the broker-dealer, Cohmad Securities Corporation, as well as its chairman, its chief operating officer and one of its registered representatives, for actively marketing investment opportunities with Madoff while knowingly or recklessly disregarding facts indicating that Madoff was operating a fraud.[6] In the second action, the Commission charged California-based investment adviser Stanley Chais, who oversaw three funds that invested all of their assets with Madoff, with fraudulently misrepresenting his role in managing the funds' assets and for distributing false account statements to investors.[7]

Tips & Complaints

In addition to vigorously enforcing the securities laws, we are upgrading our ability to keep pace with the complexity of 21st century markets, as well as the varied nature of frauds and scams.

Important questions, for instance, have been raised concerning the agency's handling of tips or whistleblower information related in particular to the activities of Bernard Madoff. That is why we are seeking legislation to incentivize whistleblowers and are revamping the process for evaluating the 2,000 tips we get each day.

We also have retained the Center for Enterprise Modernization, a federally funded research and development center operated by The MITRE Corporation, to help us establish a centralized system to more effectively identify valuable leads for potential enforcement action as well as areas of high risk for compliance examinations. The MITRE Corporation helped the SEC to scrutinize the agency's processes for receiving, tracking, analyzing, and acting upon the tips, complaints, and referrals from outside sources. Having recently completed this review, the MITRE Corporation has made recommendations to the SEC regarding how it can begin immediately to improve the quality and efficiency of the agency's current procedures, and to recommend potential technology solutions that can assist the SEC staff in more effectively tracking, managing and utilizing tips, complaints, and referrals. We are now in the process of

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6 SEC v. Cohmad Securities Corporation, Maurice J. Cohn, *Marcia B. Cohn, and Robert M. Jaffe, (S.D.N.Y. Civ. 09 CV 5680).*

7 *SEC v. Stanley Chais, (S.D.N.Y. Civ. 09 CV 5681).*

creating these new policies and procedures for the entire agency. The next phase will be to procure and implement a centralized information technology solution that will provide the agency with an automated mechanism for, among other things, tracking, analyzing and reporting on tips and complaints on an agency-wide basis.

Disgorgements

We also recognize the need to enhance the Commission's ability to collect disgorgement and penalties and to swiftly and efficiently distribute the monies to harmed investors. In recent years, this has been identified by the General Accountability Office ("GAO") as an area in need of significant improvement.

In September 2007, the Commission established a new centralized office, the Office of Collections and Distributions, to expedite the distribution of Commission recoveries to injured investors. The Office is responsible for overseeing the distribution of billions of dollars to investors who have been injured by securities laws violations, implementing the Enforcement Division's collections and distributions programs, and conducting litigation to collect disgorgement and penalties imposed in certain Enforcement actions. In addition, the Office tracks, records, and provides financial management assistance with respect to the distribution funds, and provides overall case management for the Enforcement Division.

Recently, the GAO identified the need for improvements to the Office's organizational structure. The SEC agrees with this recommendation and is working to identify and evaluate various alternatives for reforming the Office's structure, but, perhaps more importantly, is considering how best to improve the administration of the Office and ensure that its workflows and processes are run efficiently.

Strengthening Examination & Oversight

In addition to these changes, we are working to improve our risk-based oversight of broker-dealers, investment advisers, mutual funds, and other industry participants. Recently, our Office of Compliance Inspections and Examinations ("OCIE") took steps to sharpen examiners' ability to identify signs of fraud, and more broadly, improve examiners' ability to identify deficiencies and violations in today's markets. These changes should also help us to prevent another Madoff episode.

For example, to better enable our staff to conduct oversight of complex trading strategies and products that exist in today's markets, we are enhancing training for our staff and also recruiting additional professionals with expertise in securities trading, portfolio management, valuation, forensic accounting, information security, derivatives and synthetic products, and risk management. As noted above, these experts would be filling newly-created Senior Specialized Examiner positions in the examination program or serving as fellows in the new Industry and Markets Fellows Program in our Office of Risk Assessment.

We are also working to improve systems for surveillance, risk-based targeting and use of data. OCIE staff is working with the Office of Risk Assessment and other offices and divisions to identify the key data points that would improve surveillance and risk-targeting of firms and issues for examination, as well as to strengthen the use of data by examination staff, including developing a platform for delivery of analytics to examiners in the field. In addition, we are seeking to develop systems to mine data from multiple sources (including examinations, investigations, filings and tips), link the data together, and combine it with data sources from outside the SEC to assist us in determining which firms or practices raise red flags and require greater scrutiny.

Improving Transparency & Investor Protection

Custody Controls

In the wake of recent Ponzi schemes such as the Madoff fraud and other investment adviser abuses, the Commission in May proposed significant changes to the custody requirements for investment advisers. These proposals seek to protect investors' assets by developing safeguards concerning custody. This would be accomplished by focusing on the value of an independent public accountant serving as another set of eyes to better assure the safekeeping of investor assets.

One proposal would require all advisers with custody or control of client assets to engage an independent public accountant to conduct an annual "surprise exam" to verify those assets exist. A second proposal would apply only to investment advisers whose client assets are not held by a firm independent of the adviser.

In such cases, the investment adviser would be required to be subject to a review that results in a written report – prepared by an accounting firm registered with and inspected by the Public Accounting Oversight Board ("PCAOB") – that, among other things, describes the controls in place relating to custodial services, tests the operating effectiveness of those controls and provides the results of those tests. These reports are commonly known as SAS-70 reports. The reports would include an opinion of an independent public accountant issued in accordance with the standards of the PCAOB, which would provide an important level of quality control over the accountants performing this review.

In addition, advisers would be required to publicly disclose the name of the accountant conducting these reviews, so that our staff can better monitor compliance and assess adviser compliance risks. Accountants also would be required to disclose the reason for any termination or resignation from performing these reviews, which should help highlight "red flags" for regulators and investors. The public comment period on these proposals closes on July 28.

Municipal Securities

I have asked our staff to develop investor-oriented enhancements to the municipal securities market within the constraints posed by the current limitations on the Commission's authority. It is time to take additional steps to improve the information, and its timeliness, for those who buy the municipal securities that are critical to state and local funding initiatives. As a first step, tomorrow the Commission will consider a recommendation to propose enhancements to broker-dealer rules to promote greater transparency and more-timely information being provided to municipal securities investors. If the proposals are adopted, municipal securities investors should receive more complete and timely information about important events that affect their investments as well as more information about variable rate demand obligations previously exempt from these broker-dealer rules. I believe these rules would be an important step toward enabling municipal securities investors to more effectively manage and monitor their investments. We look forward to working with Congress to more effectively protect investors in the important municipal securities market by developing methods to more fundamentally address municipal securities disclosure.

Pay-to-Play

On a related note, more needs to be done to curtail so-called "pay-to-play" practices by investment advisers to public pension plans. Investment advisers that seek to influence the award of public entities' advisory contracts by, for example, making political contributions to officials able to influence the awards compromise their fiduciary obligations to the plans. Pay-to-play practices can distort the process by which investment advisers are selected and can harm advisers' public pension plan clients, which may receive inferior advisory services and/or pay higher fees. In recent years, the SEC has brought several prominent actions charging investment advisers with participating in pay-to-play schemes, and criminal authorities have brought cases involving the same or similar conduct. The Commission has multiple on-going investigations of pay-to-play practices around the country. Accordingly, I have asked the staff to revisit the Commission's 1999 proposal to address harmful pay-to-play practices, and I expect that the Commission will consider that proposal in the near future.

Dark Pools

In addition, our staff has begun exploring transparency issues related to markets known as dark pools. Dark pools are defined in various ways, but generally refer to automated trading systems that do not display quotes in the public quote stream. We have heard concerns that dark pools may lead to a lack of transparency, may result in the development of significant private markets that exclude public investors (through the use of "indications-of-interest" that function similar to public quotes except with implicit pricing), and may potentially impair the public price discovery function if they divert a significant amount of marketable order flow away from the more traditional and transparent markets. Given the potential risks posed by dark pools, the Commission will take a serious look at what regulatory actions may be warranted to respond to the potential investor protection and market integrity concerns that dark pools may raise.

Combating Abusive Short-Selling

In my brief tenure as Chairman, the issue of short selling has outpaced all others in terms of the inquiries, suggestions and expressions of concern we have received. The Commission has taken several actions in this area. In October 2008, the Commission adopted Temporary Rule 204T of Regulation SHO, which requires participants of a registered clearing agency to promptly close-out "fails to deliver" in all equity securities.[8] Since the adoption of Rule 204T, fails have declined significantly. On October 14, 2008, the Commission adopted, as a permanent rule, "naked" short selling antifraud provisions under Rule 10b-21.[9]

On April 8, 2009, the Commission unanimously voted to propose two distinct approaches to short selling restrictions.[10] One approach would impose a permanent, market-wide short sale price test, while the other would impose temporary short selling restrictions upon individual securities during periods of severe declines in the prices of those securities. On May 5, 2009, the Commission held a public roundtable to solicit the views of investors, issuers, financial services firms, self-regulatory organizations and the academic community on key aspects of these proposals. The comment period to the proposal, which closed on June 19, resulted in over 3,700 comment letters. The Commission and staff currently are reviewing the comments in an effort to determine how to address this important issue. The Commission is committed to following a thoughtful, deliberative process to determine how to best protect investors, including exploring whether additional regulation is appropriate to address potentially abusive short selling. We also are examining a variety of other trading and market related practices such as securities lending.

I recognize that strong rules and vigorous enforcement are vital to curb abusive short selling and ensure confidence in our markets. The Commission has been focused on the issue of abusive "naked" short selling since before my arrival in late January, and the Commission's regulatory actions have led to a significant decline in failures to deliver securities on time following a short sale. Moreover, our Division of Enforcement has a number of active investigations involving potentially abusive short selling in a variety of contexts.

Enhancing Regulation of Credit Rating Agencies

In response to the credit market turmoil, in February the Commission took a series of actions with the goal of enhancing the utility of nationally recognized statistical rating organizations' ("NRSROs") disclosures to investors, strengthening the integrity of the ratings process, and more effectively addressing the potential for conflicts of interest inherent in the ratings process for structured finance products. Specifically, the Commission adopted several measures to increase transparency and accountability at NRSROs in order to address concerns about the integrity of their credit rating procedures and methodologies.[11] The new requirements are designed to address practices identified, in part, by the Commission staff during its examination of the three largest NRSROs. In particular, the requirements are designed to increase the transparency of the NRSROs' rating methodologies, strengthen the NRSROs' disclosure of ratings performance, prohibit the NRSROs from engaging in certain practices that create conflicts of interest, and

[8] *See* Amendments to Regulation SHO, Release No. 34-58773 (Oct. 14, 2008).

[9] *See* "Naked" Short Selling Antifraud Rule, Release No. 34-58774 (Oct. 14, 2008).

[10] *See* Amendments to Regulation SHO, Release No. 34-59748 (Apr. 10, 2009).

[11] *See* "Amendments to Rules for Nationally Recognized Statistical Rating Organizations", February 2, 2009, http://www.sec.gov/rules/final/2009/34-59342.pdf, ("February 2, 2009 Adopting Release").

enhance the NRSROs' recordkeeping and reporting obligations to assist the Commission in performing its regulatory and oversight functions.

In conjunction with the adoption of these new measures, the Commission proposed an additional amendment which would require NRSROs to disclose ratings history information for 100% of all issuer-paid credit ratings.[12] Finally, on the same date, the Commission re-proposed an amendment that would prohibit an NRSRO from issuing a rating for a structured finance product paid for by the product's issuer, sponsor, or underwriter unless the information about the product provided to the NRSRO is made available to other NRSROs.[13]

To provide greater oversight of the NRSROs, I have also allocated additional resources to establish a branch of examiners dedicated specifically to conducting examination oversight of the NRSROs. This branch will conduct routine, special and cause examinations of the ratings agencies to review their activities and NRSRO compliance with the Credit Rating Agency Reform Act of 2006 and SEC rules.

I also have directed the Commission staff to explore possible new regulations in this area, including limiting the potential for rating shopping. One possible approach would be to require disclosure by issuers of all pre-ratings obtained from NRSROs prior to selecting a firm to conduct a rating, as well as requiring NRSROs to provide additional disclosures. In addition to these and other regulatory actions pertaining to NRSROs we are exploring, we are committed to working with Congress to ensure a strong and robust regulatory framework for NRSROs.

Strengthening Shareholder Rights

Public companies and their boards of directors should be accountable to their shareholders.

To this end, in May we proposed rules that would remove obstacles to shareholders' exercising their rights to nominate company directors. Specifically, under the proposal, shareholders meeting certain requirements who have a state law right to nominate directors would be able to have a limited number of their candidates included in the company's proxy materials, thereby providing all shareholders with a meaningful and cost-effective way to choose between competing candidates. On July 1st, the Commission also proposed a series of additional measures seeking to improve other proxy disclosure and the process by which shareholders exercise their franchise rights. Today, a company must discuss the risk considerations of its compensation policies and decisions with respect to named executive officers. Under the proposals, that type of information would be required about a company's overall compensation policies—applicable to employees beyond the executive officers. Recent events clearly show that shareholders can be affected negatively if incentives drive behavior that isn't consistent with the company's overall interests. Shareholders should have access to this type of information. These new disclosure requirements would also include expanded information about the qualifications of directors, executive officers and nominees; the board's leadership structure; and

12 *See* "Re-proposed Rules for Nationally Recognized Statistical Rating Organizations," February 2, 2009, http://www.sec.gov/rules/proposed/2009/34-59343.pdf ("February 2, 2009 Re-proposing Release").

13 *See* February 2, 2009 Re-proposing Release.

potential conflicts of interest of compensation consultants. The proposals would also improve the reporting of annual stock and option awards to company executives and directors, as well as to require quicker reporting of election results. In addition, the proposals would accelerate the timing of disclosure of voting results. There is no reason for shareholders to have to wait, perhaps as long as a few months, to find out the results of voting.

At our July 1st meeting, the Commission also approved changes to NYSE rules by eliminating the ability of brokers to use their own discretion in voting their customers' uninstructed shares in director elections. This action recognizes the importance of director elections, and seeks to ensure that those voting in these elections have a financial interest in the outcome. We also announced that, later this year, we will undertake a comprehensive review of other potential improvements to the proxy voting system. With over 800 billion shares being voted annually at over 7,000 company meetings, it is imperative that our proxy voting process work and work well, beginning with the quality of disclosure and continuing through to the integrity of the vote results.

Improving Money Market & Mutual Fund Regulation

On June 30, in response to the credit crisis' impact on money market funds, the SEC issued a comprehensive set of proposals to strengthen the money market fund regulatory regime. The proposals focus on tightening the credit quality, maturity and liquidity standards for money market funds to better protect investors and make money market funds more resilient to risks in the short-term securities markets such as those that unfolded last fall. In addition, the proposals would require money market funds to stress test their portfolios and report their portfolio holdings each month to permit investors and regulators to better assess their risk characteristics. The proposals also seek to facilitate an orderly liquidation of any money market fund that has "broken the buck" (re-priced its securities below $1.00 per share) by requiring funds to have the capability to process trades at prices other than $1.00 and permitting them to suspend redemptions in order to distribute assets in an orderly manner. In addition, the SEC requested comment on whether more fundamental changes may be warranted, such as converting money market funds to a floating rate net asset value, in order to better protect investors from abuses and runs on the funds. Comments on this proposal are due by September 8.

In addition, on June 18, the SEC and the Department of Labor held a joint hearing on target date funds. Target date funds and other similar investment options are investment products that allocate their investments among various asset classes and automatically shift that allocation to more conservative investments as a "target" date approaches. These funds have become popular, with growth in target date fund assets likely to continue since these funds can be default investments in 401(k) retirement plans under the Pension Protection Act of 2006. Target date funds, however, recently have produced some troubling investment results. The average loss in 2008 among 31 funds with a 2010 retirement date was almost 25 percent. In addition, varying strategies among these funds produced widely varying results, as returns of 2010 target date funds ranged from minus 3.6 percent to minus 41 percent.

These returns cause concern for investors and regulators alike. I can assure you that our staff is closely reviewing target date funds' disclosure about their asset allocations. In addition, in connection with our joint hearing with the Department of Labor, we will consider whether additional disclosure measures are needed to better align target date funds' asset allocations with investor expectations. One issue I have asked our staff to examine closely is the use of a particular target date in a fund's name and whether that should be restricted or prohibited. The staff also is considering whether the SEC rule governing a fund's name should be revised to require clarification when a particular target date is used. Finally, I have asked the staff to reconsider our disclosure requirements to determine whether improvements can be made to enhance investor understanding of target date funds.

I also have asked the staff to prepare a recommendation on rule 12b-1, which permits mutual funds to use fund assets to compensate broker-dealers and other intermediaries for distribution and servicing expenses. These fees, with their bureaucratic sounding name and sometimes unclear purpose, are not well understood by investors. Despite this, in 2008, aggregate rule 12b-1 fees amounted to more than $13 billion. It is essential, therefore, that the SEC engage in a comprehensive re-examination of rule 12b-1 and the fees collected pursuant to the rule. If issues relating to these fees undermine investor interests, then we at the SEC have an obligation to adjust our regulations.

Filling Regulatory Gaps / Legislative Reforms

President Obama recently unveiled his plan to build the foundation for a stronger and safer financial system. I believe the plan makes real progress in filling gaps in our financial regulatory framework that became apparent in the wake of the financial crisis. Although the SEC is just one part of that landscape, in my view the proposals described in the Administration's white paper do much to strengthen the SEC and improve investor protection in the process.

The plan seeks to create a systemic risk regulator to help reduce the likelihood of a systemic shock; an oversight council so that all aspects of financial markets regulation can be taken into account and so that there are a diversity of viewpoints; and a financial consumer protection agency that will look after the interests of those who purchase credit products. It also seeks legislation to regulate hedge fund managers, over-the-counter derivatives such as credit default swaps , and other inadequately regulated areas so that there are certain basic safeguards in place for investors.

In an effort to shed sunlight on the unregulated world of CDS, the Commission, working in close consultation with the Board of Governors of the Federal Reserve System and the Commodity Futures Trading Commission ("CFTC") and operating under the limitations of the current legislative structure, recently issued temporary orders to facilitate the establishment of three central counterparties for clearing CDS (LCH.Clearnet Ltd., ICE US Trust LLC, and Chicago Mercantile Exchange Inc.). We have also been engaging in a continuing dialogue with the CFTC to seek to fill regulatory gaps and search for ways to harmonize our regulatory approaches, where appropriate, in this and other areas.

More needs to be done, however, and in building a new regulatory framework for OTC derivatives, it is vital that the system be designed to protect the public interest, manage systemic risk, and promote capital formation and general economic welfare. A core principle should be reducing the opportunity for regulatory arbitrage by ensuring that equivalent products are regulated in a similar manner. I look forward to working with Congress to make the necessary legislative changes to ensure that these markets and market participants are appropriately regulated.

In addition, I believe that hedge funds and other unregulated private pools of capital have flown under the radar for far too long. I support the recommendation in the Administration's white paper that advisers to hedge funds and other private pools of capital should be required to register with the SEC under the Investment Advisers Act. I believe that such registration and the resulting oversight would enable investors, regulators and the marketplace to have more complete and meaningful information about these advisers, the funds they manage and their market activities.

I look forward to working with Congress on this important issue and on related issues regarding the level of additional resources that would be necessary if private fund managers were required to register with the SEC. I note that the SEC currently has only about 450 examiners to oversee 11,300 investment advisers and 8,000 mutual funds. If advisers to hedge funds, private equity funds and venture capital funds were required to register with the SEC, as contemplated by the Administration's white paper, our staff roughly estimates that approximately 2,000 additional investment advisers would register. While our staff has experience overseeing and examining private fund advisers, and we would bring that experience to bear with respect to any additional responsibilities in this area given to us by Congress, significant additional resources would be necessary for the Commission to take on additional responsibility in this area.

We are also closely examining the broker-dealer and investment adviser regulatory regimes and assessing how they can best be harmonized and improved for the benefit of investors. Many investors do not recognize the differences in standards of conduct or the regulatory protections applicable to broker-dealers and investment advisers. It is essential that when investors receive similar services from similar financial service providers, the service providers should be subject to the same standard of conduct and regulatory requirements, regardless of the label attached to the providers. I therefore believe that all financial service providers that provide personalized investment advice about securities should owe a fiduciary duty to their customers or clients and be subject to equivalent regulation. I support the standard contained in the bill Treasury recently put forth, which would require broker-dealers and investment advisers to act solely in the interests of their customers or clients when providing investment advice.

Finally, there are a number of other possible legislative changes that Commission staff have identified to help the Commission to better protect investors. These include:

- Authorizing a whistleblower program to incentivize insiders to provide information leading to the successful enforcement of the federal securities laws;

- Enhancing the Commission's ability to require ongoing disclosure in trading markets with respect to securities and beneficial ownership;

- Giving the PCAOB authority to inspect auditors of broker-dealers, as included in H.R. 1212 introduced by Chairman Kanjorski;

- Eliminating the statutory provision that prohibits broker-dealers from competing on price when selling mutual fund shares;

- Authorizing the SEC to verify client assets with mutual fund and adviser custodians;

- Establishing "aider and abettor" Commission causes of action in those areas of the law in which it does not currently exist (e.g., Securities Act and the Investment Company Act);

- Providing for nationwide service of process in civil actions filed in federal courts;

- Authorizing the release of certain grand jury information to Commission staff for use in matters within the Commission's jurisdiction; and

- Expanding the sanctions available to the Commission (e.g., through collateral bars and penalties for aiding and abetting under the Investment Advisers Act).

I look forward to working with this Subcommittee as you develop legislation in these and other areas.

SEC Resources

The entire agency has been hard at work on these and other initiatives to reinvigorate the SEC and better protect investors. While a number of these efforts do not require additional resources, I do believe that the SEC has been significantly underfunded in recent years, and that sufficient budgetary resources are part of enhancing its effectiveness as the overseer of our nation's securities markets.

Beginning in FY2005, the SEC faced three consecutive years of flat or declining budgets, the end result being a 10 percent reduction in its workforce and a cut of more than 50 percent in its new technology investments. This occurred at the same time that the securities markets we regulate were growing significantly in size and complexity. Since 2005, when these cutbacks began, average daily trading volume has nearly doubled; the investment advisor industry has grown by over 30 percent in number and over 40 percent in assets under management; and broker-dealer operations have expanded significantly in size, complexity, and geographic diversity.[14]

[14] For additional detail, see the attached appendix, "SEC Staff Levels Have Not Kept Pace with Industry Growth."

With Congress's support, the SEC recently has begun rebuilding its workforce and technology program. I also am very grateful that the President has requested $1.026 billion for the SEC in FY 2010, an increase of nearly 6 percent in budget authority over the FY 2009 level. This request would permit the SEC to continue restoring lost staff and add badly needed dollars to our IT program, rejuvenating our efforts to uncover and prosecute fraud and oversee the securities markets.

The President's FY 2010 request is a key step in what I hope will be a multi-year effort to expand significantly the staff and resources available to the SEC, so it can close the gap with fast-growing markets and promote strong protections for investors. For FY 2011, the Commission submitted to Congress an Authorization request of over $1.2 billion, a 21 percent increase over the FY 2010 request. This amount would support over 375 additional full-time equivalents and $30 million in new technology investments, mainly in the enforcement, examination, risk assessment, and market oversight functions. In the last few weeks, our House and Senate Appropriations Subcommittees approved additional funding for the agency for FY 2010. If Congress votes to provide these additional funds, the agency would use these dollars in FY 2010 to accelerate the staff and IT enhancements contemplated in our FY 2011 request.

I want to thank you for your continued strong support for the SEC and its critical mission. I believe the steps I have outlined here – strengthening our enforcement program and enhancing oversight of the markets – are essential for restoring investors' confidence in both the SEC and in our nation's securities markets.

I would be happy to answer any questions you may have.

Protect industry from predatory speculators

By Lawrence Mitchell
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Senator Charles Schumer's plan to enact a "Shareholder Bill of Rights" and the Securities and Exchange Commission's shareholder access proposal show the harm that can come from crisis lawmaking. These proposals are misplaced populist attempts to regulate quickly amid the disarray. But shareholder rights is an issue that had almost nothing to do with the financial collapse, and threatens, in the long run, to hobble the corporate governance system that built American industry.

In the first place, shareholders are hardly an oppressed class. The beneficiaries of shareholder access rules will be the pension funds and mutual funds who hold billions of dollars of corporate stock. True, they hold it on behalf of ordinary Americans, but the managers of these funds have their own interests that often conflict with those of their beneficiaries. Managers thrive by increasing their portfolios' value. That is a hard thing to do and it takes time. So for years fund managers have increased their pay by putting pressure on corporate managers to increase short-term stock prices at the expense of long-term business health. Doing business that way puts jobs and sustainable industry at risk, now and in the future.

For example, managers responded to the pressure by using their retained earnings to engage in large stock buybacks. In the three years to September 2007, companies in the S&P 500 used more money to buy back stock than to invest in production. With retained earnings gone, all that was left to finance production was debt. When the credit markets collapsed, these corporations could not borrow, and thus could not produce. Are boards and managers to blame? Sure. But so are the big shareholders who have been pushing management for this kind of behaviour for years. They are more the problem than the solution. Enhancing their voting rights will only make things worse.

Another flaw in these approaches is the assumption that these institutions somehow are investors. They are not. They are traders. In recent years, annual turnover on the New York Stock Exchange has topped 120 per cent, compared with historical rates averaging in the teens and twenties before 1980. Mutual fund turnover has reached 110 per cent, and pension funds, whose investment horizons should theoretically be forever, have had turnovers in the 90 per cent range. These rates hardly suggest a long-term perspective; they show that even our pension funds engage in extensive speculation. It is true that the SEC and Schumer proposals both demand a holding period before a shareholder is allowed to nominate directors, but no requirement that it hold the stock after the vote. This creates incentives for institutions to strong-arm management to increase share prices and then sell out as soon as they are done, regardless of the long-term effects on the business.

Do we really want speculators telling corporate boards how to manage their businesses? Those who say "yes" want to increase short-term management pressure and thus share prices, regardless of the corporate mutilation this induces. They do not seem to care that their profits come at the expense of future generations' economic well-being. But if our goal is to give expert managers the time necessary to create long-term, sustainable, and innovative businesses, the answer is a clear "no".

These misguided proposals also rely on the notion that a corporation is a democracy. Whatever the corporation is, it is assuredly not a democracy. As the great business historian, Alfred Chandler, demonstrated, the American corporation has succeeded in large part because it is a wonderfully constructed bureaucracy. Bureaucracies do not work when they are operated by town meeting. It is worth remembering that the golden era of US business occurred at a time when the shareholder vote was considered meaningless. We should also remember that the nations with whom we compete for business all recognise the importance of centralised management and bureaucracy to corporate success and economic growth.

The proposals are fighting the last war. Inattentive boards of non-financial companies may have been a big factor in the corporate scandals at the start of the century. But it is hyperbolic to suggest, as the Schumer bill does, that this had anything significant to do with the current recession. The Schumer bill and the SEC proposal only exacerbate the problem by chaining boards to the ball of stock prices – which helped to cause those scandals in the first place.

Shareholders do need protection from inattentive and irresponsible boards, but it would be far more effective to strengthen the rules that regulate sloth and theft than to risk choking the engine of real economic production. Managers, not shareholders, are expert at running our businesses. Shareholder rights are simply wrong.

The writer, a law professor at George Washington University, is author of 'The Speculation Economy: How Finance Triumphed Over Industry'

CERTIFIED FINANCIAL PLANNER BOARD OF STANDARDS, INC.

CFA Consumer Federation of America

NASAA

FPA FINANCIAL PLANNING ASSOCIATION The Heart of Financial Planning

Fund Democracy

INVESTMENT ADVISER ASSOCIATION

NAPFA The National Association of Personal Financial Advisors

BY ELECTRONIC DELIVERY

July 14, 2009

The Honorable Barney Frank
Chairman
The Honorable Spencer Bachus
Ranking Member
House Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Re: Section 913 of Administration's Proposed Legislation to Strengthen Investor Protection

Dear Chairman Frank and Ranking Member Bachus:

Certified Financial Planner Board of Standards (CFP Board), the Consumer Federation of America (CFA), the Financial Planning Association (FPA), Fund Democracy, the Investment Adviser Association (IAA), the National Association of Personal Financial Advisors (NAPFA), and the North American Securities Administrators Association (NASAA)[1] are writing to express our strong support for the proposal in the Administration's White Paper on financial regulatory reform to subject all those who provide investment advice to a fiduciary duty to act in their clients' best interests. Moreover, we are pleased at the speed with which the Treasury Department has moved to adopt these reforms, proposing the "Investor Protection Act of 2009" last week, which incorporates this and other investor protection priorities.

Although our organizations represent diverse interests and constituencies, including state securities regulators, consumer groups, and industry and professional groups related to investment advisers and financial planners, we share the view that the highest legal standard—a fiduciary duty—should apply to all who give financial advice to clients. Over the years, we have looked on in dismay as brokers have been allowed to offer extensive advisory services, and market their services based on the advice offered, all without having to comply with the Investment Advisers Act of 1940 (Advisers Act). The Administration's White Paper demonstrates a clear understanding of the problem and proposes the appropriate solution—a fiduciary duty for all.

Section 913 of the proposed legislation—entitled "Establishment of a Fiduciary Duty for Brokers, Dealers, and Investment Advisers, and Harmonization of the Regulation of Brokers, Dealers, and Investment Advisers"—seeks to accomplish that goal, though we fear it may fall short. It authorizes but does not require the SEC to issue rules under the Securities Exchange Act of 1934 (the primary federal law regulating broker-dealers) and the Advisers Act (the primary federal law regulating investment advisers) that "in substance" provide that the "standards of conduct for all brokers, dealers, and investment advisers, in providing investment advice about securities to retail customers or clients ... shall be to act solely in the interest of the customer or client without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice."[2]

While we applaud the intent evident in this provision and believe it represents a good starting point, we believe revisions will be needed to unambiguously provide for the extension of the *overarching* fiduciary duty that investment advisers owe their clients under the Advisers Act to brokers and others who provide investment advice, that this fiduciary duty is explicitly recognized in law, and that the legislation does not in any way undermine the fiduciary duty that already exists under the Advisers Act.

We greatly appreciate the Administration's efforts in putting forward this legislation and look forward to working with you and members of this Committee to ensure that the Administration's intent to bolster investor protections is fully realized.

Respectfully,

Kevin R. Keller, CAE
Chief Executive Officer
CFP Board

Barbara Roper
Director of Investor Protection
CFA

Marvin W. Tuttle Jr., CAE
Executive Director and CEO
FPA

Mercer Bullard
Founder and CEO
Fund Democracy

David G. Tittsworth
Executive Director
IAA

Fred J. Joseph
President
NASAA

Ellen Turf
Chief Executive Officer
NAPFA

Cc: House Financial Services Committee Members
The Honorable Mary L. Schapiro, Chairman, U.S. Securities and Exchange Commission
The Honorable Timothy F. Geithner, Secretary of the Treasury, U.S. Department of the Treasury

[1] CFP Board is a non-profit organization that acts in the public interest by fostering professional standards in personal financial planning through setting and enforcing education, examination, experience, and ethics standards for financial planner professionals who hold the CFP® certification. CFP Board's mission is to benefit the public by granting the CFP® certification and upholding it as the recognized standard of excellence for personal financial planning. CFP Board currently regulates nearly 60,000 CFP® professionals who agree, on a voluntary basis, to comply with our competency and ethical standards and subject themselves to the disciplinary oversight of CFP Board under a fiduciary standard of care.

CFA is a non-profit association of approximately 280 pro-consumer groups, representing more than 50 million Americans. It was established in 1968 to advance the consumer interest through research, education, and advocacy.

FPA® is the leadership and advocacy organization connecting those who provide, support, and benefit from professional financial planning. FPA demonstrates and supports a professional commitment to education and a client-centered financial planning process. Based in Denver, Colo., FPA has close to 100 chapters throughout the country representing more than 29,500 members involved in all facets of providing financial planning services. Working in alliance with academic leaders, legislative and regulatory bodies, financial services firms, and consumer interest organizations, FPA is the community that fosters the value of financial planning and advances the financial planning profession.

Fund Democracy is the leading voice for America's mutual fund shareholders. It has spoken out on mutual fund issues in financial publications such as TheStreet.com, Barron's, SmartMoney.com, and others. Fund Democracy also has engaged in a number of advocacy initiatives on behalf of mutual fund shareholders.

IAA is a not-for-profit organization that represents the interests of SEC-registered investment advisory firms. Founded in 1937, its membership today consists of more than 450 firms that collectively manage in excess of $7 trillion in assets for a wide variety of individual and institutional investors. For more information, please visit www.investmentadviser.org.

Since 1983, NAPFA has provided Fee-Only financial planners across the country with some of the strictest guidelines possible for professional competency, comprehensive financial planning, and Fee-Only compensation. With more than 2,000 members across the country, NAPFA has become the leading professional association in the United States dedicated to the advancement of Fee-Only financial planning. For more information on NAPFA, visit www.napfa.org.

NASAA is the oldest international organization devoted to investor protection. NASAA is a voluntary association whose membership consists of 67 state, provincial, and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico. For more information, visit: www.nasaa.org.

[2] This section also authorizes the SEC to issue regulations to "facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with investment professionals" and to prohibit "sales practices, conflicts of interest, and compensation schemes for financial intermediaries (including brokers, dealers, and investment advisers) that it deems contrary to the public interest and the interests of investors."

July 14, 2009 Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises hearing entitled "SEC Oversight: Current State and Agenda"

Question from Representative Biggert

First of all, what is your opinion of the new derivative tax that has been proposed in the recently passed cap and trade bill? Do you support it, or do you have fears that such a tax and additional restrictions will send U.S. businesses and jobs abroad?

The SEC is charged with protecting investors by regulating securities transactions and securities markets. As such, it is not involved in evaluating the effects of tax policy on securities or derivatives transactions. I, therefore, do not have a view as to the tax effects on cap and trade nor the implications of such tax policy on derivatives transactions being entered into outside the United States.

July 14, 2009 Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises hearing entitled "SEC Oversight: Current State and Agenda"

Questions for Record from Congressman Himes

Question 1
Does the SEC plan to take action against the 70+ brokerage firms, and their managers, and their agents, for acting as agents and market makers selling the 622 Billion unregistered CMKM Securities?

We take very seriously any potential violations of the federal securities laws, including violations of the securities registration provisions.

In April 2008, the SEC named NevWest Securities, Inc. ("NevWest"), three current or former NevWest employees, and ten other defendants in a civil action filed in the United States District Court for the District of Nevada for the alleged illegal issuance and sale of unregistered stock of CMKM Diamonds, Inc. ("CMKM"), purportedly a diamond and gold mining company located in Las Vegas. The Commission's complaint alleges that, from January 2003 to May 2005, CMKM improperly issued up to 622 billion shares of purportedly unrestricted stock.

NevWest and its three current or former employees played a major role in the alleged stock distribution scheme. Defendant John Edwards, whom the SEC alleges to be the scheme's mastermind, deposited 597 CMKM stock certificates totaling more than 261 billion shares at NevWest Securities, or more than 30% of the company's authorized shares as of May 2005. NevWest registered representative Daryl Anderson, who handled Edwards' transactions, thereafter sold almost 260 billion shares of CMKM stock and reaped about $2.3 million in commissions. In January 2009, the court awarded the SEC summary judgment against Anderson, ordering him to pay $2,490,211.04 in disgorgement and prejudgment interest and a penalty of $2,300,000. The Commission previously had barred Anderson from associating with any broker or dealer.

As in any other case, in order to maximize our resources and achieve the desired deterrent effect, we have been and will continue to focus our efforts on the central perpetrators in this scheme.

Question 2
The SEC has been investigating the trading of CMKM shares by company insiders as early as 2003. What became of the original investigations? Why did it take the SEC until April 7, 2008 to file a formal complaint?

In addition to its April 2008 action alleging fraud against fourteen defendants, the Commission has brought four actions concerning CMKM:

- In March 2005, the Commission issued an Order of Suspension of Trading in CMKM. See Trading Suspension of CMKM Diamonds, Inc., aka Casavant Mining Kimberlite International, Inc., Release No. 34-51305 (March 3, 2005).

- In March 2005, the Commission issued an Order Instituting Proceedings pursuant to Section 12(j) of the Exchange Act alleging that the company failed to file required periodic reports and seeking to revoke the registration of the company's securities. In July 2005, an administrative law judge ordered the revocation of CMKM's securities registration, a decision that the Commission upheld in October 2005 upon a petition by CMKM for further review. See Decision, In the Matter of CMKM Diamonds, Inc., Initial Decision Release No. 291, Admin. Proc. File No. 3-11858 (July 12, 2005); Securities Exchange Act of 1934 Release No. 52694 (October 28, 2005) (Order Dismissing Review Proceedings and Notice of Finality).

- In September 2008, the Commission initiated an administrative action to bar Daryl Anderson, the registered representative at NevWest who sold 259 billion unregistered CMKM securities into the market and reaped about $2.3 million in commissions. See In the Matter of Daryl Anderson, Admin. Proc. File No. 3-13156 (September 2, 2008) (Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Notice of Hearing). In November 2008, the Commission issued an order barring Anderson from associating with any broker or dealer. See Securities Exchange Act of 1934 Release No. 58958 (November 14, 2008) (Order Making Findings and Imposing Remedial Sanctions Pursuant to Section 15(b) of the Securities Exchange Act of 1934).

- In January 2009, the Commission filed a civil injunctive action against an individual who repeatedly executed transactions in CMKM stock without being registered as a broker-dealer and without public information available about the company. See Securities and Exchange Commission v. Marco Glisson, Civil Action No. 2:09-cv-00104 (D. Nevada), Litigation Release No. 20855 (January 15, 2009).

Links to all of these actions, including the April 2008 complaint, are available on the SEC's website under "Investor Alerts." This CMKM investor information site contains additional public information regarding the CMKM matter. The link is http://www.sec.gov/divisions/enforce/claims/cmkmopinion062309.htm.

Most recently, in September of this year the United States Attorney's Office in Nevada unsealed criminal indictments against six defendants charging securities fraud related to CMKM. See United States of America v. John Edwards, Urban Casavant, Helen Bagley, Brian Dvorak, Ginger Gutierrez, and James Kinney, CR-00132-RLH-RJJ. Information can be found at http://www.usdoj.gov/usao/nv/press/september2009/cmkm09212009.htm.

<u>Question 3</u>
Why has the SEC brought charges against one very small broker/dealer, NevWest, but not against the other broker dealers who cleared the 622 Billion CMKM securities?

As alleged in the SEC's complaint, NevWest played a major role in the CMKM stock distribution scheme. From March 2003 through May 11, 2005, Edwards, the scheme's mastermind, through NevWest, sold nearly 260 billion shares of CMKM stock in 569 separate transactions, generating proceeds of more than $53.3 million. All of those sales were transacted through NevWest. By May 2005, Edwards had sold more than 32% of CMKM's total authorized shares through NevWest.

July 14, 2009 Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises hearing entitled "SEC Oversight: Current State and Agenda"

Questions for the Record from Congressman Putnam

Question 1

What regulatory steps, if any, are in place to assist clients of small brokerage firms who own auction rate securities (ARSs), specifically auction rate preferreds (ARPs), who may have inadvertently helped investors get involved?

Enforcement actions have been the Commission's primary means of assisting investors who were left with illiquid ARS holdings as a result of the freezing of the ARS market in February of 2008.

In August 2008, the Commission's Division of Enforcement began announcing preliminary settlements-in-principle with a number of large brokerage firms that would give individual investors, small businesses, charities and institutional investors billions of dollars of their money back from ARSs they purchased from the firms. Smaller investors were repaid first. Settlements with Citigroup, UBS, Wachovia, Bank of America, RBC and Deutsche Bank have been finalized and will return approximately $43.3 billion to investors. These settlements were based on the legal theory that these firms knowingly or recklessly failed to disclose material information to customers regarding the liquidity risks associated with investing in ARS. In July of 2009, the Commission also filed a litigated action against Morgan Keegan based upon the same legal theory.

In July of 2009, the Commission announced settled charges against TD Ameritrade, Inc. for making inaccurate statements when selling ARSs to customers. This settlement marks the first such settlement with a so-called "downstream" broker-dealer (i.e., one that did not underwrite and/or manage an offering of auction rate securities). This settlement is based on the legal theory that the broker-dealer, in selling the ARS securities to its customers, misrepresented the securities as cash equivalents and failed to adequately disclose the risks of those instruments to customers. Thus far, the firm has purchased eligible ARSs totaling approximately $266 million.

To the extent that a firm's ARS-related activities were purely "inadvertent," there may be no basis for enforcement action.

Commission staff also has provided no-action relief as part of its efforts in the wake of the ARS crisis. For example, on September 22, 2008, the Staff of the Divisions of Corporation Finance, Investment Management and Trading and Markets provided temporary exemptive and no-action relief to financial industry participants from many of the tender offer and going private rules under the Exchange Act and the beneficial ownership and reporting requirements under Section 30(h) of the Investment Company Act and Section 16 of the Exchange Act, to facilitate firms' repurchases of ARSs. Firms wishing to rely on the relief were required to structure their offers pursuant to a specified offer protocol, including, among other matters, that the offers to purchase would be made at par (plus dividends or accrued but unpaid interest, if any).

Issuers of ARS have seen the interest rates they must pay on these securities increase dramatically due to the liquidity issues in the marketplace. To address this issue, some issuers of ARS, including certain closed-end funds, have redeemed shares (generally at par value) to re-structure their debt at lower rates. In many cases, the issuers have called the entire issue for redemption. In other instances, the issuers only offered to redeem some of the outstanding shares.[1] These redemptions have assisted both investors and broker-dealers by allowing them to exit those ARS positions.

<u>**Question 2**</u>

As you are well aware, large securities firms have entered into deals/settlements to buy back ARSs from their clients. Whether a large firm or a small firm, ARPs are purchased from the same desk. As some clearing firms are wholly owned subsidiaries of a larger firm, what pressure currently exists for clearing firms to repurchase ARPs?

The Commission's actions were generally brought against the broker-dealer entity or entities within each conglomerate group based upon the legal theory applicable as to that broker-dealer (as described above in response to item #1). For instance, in our action against UBS, the two registered broker-dealers that had engaged in the actionable activities, UBS Securities LLC and UBS Financial Services Inc., were named as respondents.

We understand that investors interested in finding liquidity may be able to put up ARSs for collateral on loans, and that there is an expanding secondary market for ARSs facilitated by firms such as SecondMarket Inc. that specialize in arranging sales of illiquid assets. Additionally, we believe that all firms have a reputational interest in buying back ARSs to the extent to which they are able.

<u>**Question 3**</u>

You've stated that it is essentially the Commission's goal to strengthen the SEC's role in helping to address the financial crisis, and to improve investor protection and restore confidence in our markets. Per remarks you made in October of 2008, *"In 2006, institutional investors owned about 80 percent of auction rate securities. But by the end of 2007, that number had plummeted to 30 percent. It's clear many institutions understood the risk in terms of their own investments, but the question is: was that*

1 In the case of such partial redemptions, the issuer would notify the Depository Trust Company (DTC) that it intends to issue a call for partial redemption. DTC would then allocate the redemptions among broker-dealers for which it is holding shares in that issuance using an impartial system. Each broker-dealer that received an allocation would then identify how it will allocate those redemptions among its customers. A broker-dealer holding ARS shares may not receive any redemption allocation from DTC. Further, a broker-dealer that does receive an allocation may not receive enough redemptions to redeem all of its customers' shares. FINRA Rules require broker-dealers to adopt procedures to reasonably allocate the partial redemptions they receive from DTC among their customers on a fair and impartial basis.

***information freely shared with other investors? There was both a legal and an ethical obligation to do so."* Would you please share your thoughts on making additional information available to ARSs investors, specifically the potential liquidity risk involved?**

Greater transparency regarding liquidity risks is absolutely necessary in this area. I believed then, and still believe now, that broker-dealers are under an obligation to provide sufficient information to their customers so that their customers adequately understand the liquidity and other risks surrounding their investments. A failure to provide additional information concerning these risks was the basis of the Commission's seven settled enforcement actions brought to date against broker-dealers. Going forward, we will not hesitate to recommend enforcement actions should we conclude that a firm's failure to sufficiently disclose liquidity risks violated the securities laws.

Question 4

What direct measure(s) is the SEC and/or FINRA (through SEC oversight) taking to assist small brokerage firms through the illiquidity of ARPs?

In March of 2008, FINRA issued *Regulatory Notice 08-08*, which increased the customer margin requirements on fixed income ARSs (*i.e.*, municipal auction rate securities and student loan auction rate securities) due to concerns about reduced liquidity in the market resulting from failed auctions in such securities. This guidance required that when a broker-dealer made a margin loan to a customer using fixed income ARS as collateral, the ARS securities had less collateral value than they had previously in recognition of the fact that if the customer failed to repay and the broker-dealer had to foreclose on the collateral it may have issues liquidating those securities.

Subsequently, in two related letters from FINRA to the Commission (dated April 11, 2008 and April 24, 2008), FINRA issued interpretive guidance based upon discussions with Commission Staff, that provided firms with temporary relief from the customary net capital charges applicable to margin loans extended to customers on ARPs (because they were not readily marketable) under certain circumstances. This was done to help firms provide liquidity to customers who owned ARPs.

In April of 2008, FINRA also issued guidance to broker-dealers on partial redemptions of ARSs. FINRA's *Regulatory Notice 08-21* reminds broker-dealers that when allocating partial redemptions of ARSs among their customers, they are required to adopt procedures that are reasonably designed to treat customers fairly and impartially, and must put their customers' interests ahead of their own.

Finally, on April 30, 2008, FINRA issued an Investor Alert titled, "Auction Rate Securities: What Happens When Auctions Fail." This Investor Alert was designed to educate customers regarding issues relating to auction rate securities.

Question 5

Do you think it is necessary to create a type of "liquidity facility" to assist investors redeem their money?

Over time, market forces have helped and are likely to continue to help more investors exit this market. In our experience, market conditions have improved and issuers are successfully bidding on their own ARSs. We understand that local governments have converted to other types of municipal securities or earmarked for redemption more than half of the municipal auction-rate bonds. However, it can take some time for issuers and conduit borrowers to restructure their debt and arrange new financing. Improving conditions in the credit markets, enhanced price transparency, secondary market trading activity, enforcement actions that require repurchases and the desire of issuers and broker-dealers to help their investors where possible, are also helping to alleviate illiquidity. Nonetheless, billions of dollars of ARS investments remain "frozen."

ARSs backed by student loans have been particularly hard hit. Interest rates are resetting to very low levels, or in some cases to zero percent, pursuant to bond provisions that prevent rates from rising for an extended period of time to assure that payments to bondholders don't exceed the amount of interest payments received from student-loan borrowers. Financing costs in the student-loan market have increased sharply, making it difficult to refinance existing trusts. Accordingly, it may be less likely that investors in student-loan ARS will be able to get their principal back prior to maturity absent the creation of a liquidity facility or some other form of market intervention.

Question 6

What are the benefits and consequences of creating a centralized system for the collection and distribution of critical market information about auction rate securities?

A robust centralized system for the collection and distribution of critical market information about auction-rate securities may encourage market participation and improve liquidity. For example, it could help an investor still "stuck" in the securities to sell them to others. Improved transparency may also promote price discovery, facilitate best execution, and reduce the potential for fraud.

At the request of SEC staff, the Municipal Securities Rulemaking Board recently began including information regarding municipal ARSs in a component of its new Electronic Municipal Market Access (EMMA) system known as "SHORT" (Short-term Obligation Rate Transparency). The new SHORT system is a centralized system for the collection and distribution of information about municipal ARSs, but it does not include non-municipal ARSs, such as ARPs and corporate ARSs. The first phase of SHORT, which includes information regarding the current interest rates for municipal ARSs and certain related information, such as the maximum and minimum permitted rates, interest rate period, and maturity date, is now publicly available at no charge on EMMA at www.msrb.emma.org. The MSRB plans, subject to SEC approval, to add further information regarding municipal ARSs, including bidding information for ARSs auctions similar to that available for auctions of U.S. Treasury securities, early in 2010. The

MSRB published its proposed plans for comment on July 14, 2009, see http://www.msrb.org/msrb1/whatsnew/2009-43.asp.

Some municipal dealers have expressed concern that an expanded centralized system in the municipal ARS market would impose additional costs on them for a market that they indicate may eventually shrink substantially or disappear, noting the lack of new ARSs being issued. Nonetheless, investors in billions of dollars of municipal ARSs and other ARSs are still unable to exit this market since its collapse in February 2008; a centralized system and the additional transparency it may bring could help these investors and the ARS market generally by promoting a more active market.

Question 7

During a hearing in September of 2008, testimony by Linda Chatman Thomsen, Director, Division of Enforcement at the SEC, stated that, *"The Enforcement Division formed a nationwide ARS Working Group."* Without divulging any information from on-going investigations, would you please provide an update on findings of the Working Group and potential recommendations from these findings?

The Division of Enforcement (Enforcement) formed the ARS Working Group in June 2008 to coordinate the efforts of Enforcement with respect to the various investigations staff was conducting nationwide concerning the February 2008 seizure of the market for ARSs. The SEC's investigations revealed that many ARS investors had been misled about the risks in the ARS market and were wrongly led to believe that ARSs were as liquid as cash or money market funds. When the ARS market froze, these investors had no access to funds many of them needed for pressing short-term obligations, such as down-payments on homes, college tuition, or in the case of small businesses, payroll expenditures. Enforcement, working in close coordination with state regulators and FINRA, focused on the two largest firms in the ARS market, Citigroup and UBS. In tandem with other regulators, by July 2009 the Enforcement Division finalized settlements with seven broker-dealer firms in the ARS market (UBS, Citigroup, Wachovia, Deutsche Bank, Bank of America, RBC, and TD Ameritrade) and has entered into a settlement-in-principle with another firm, Merrill Lynch. As a result of the SEC settlements, tens of thousands of ARS investors have had or will receive over $50 billion of liquidity (more than $67 billion in total has been received when state and FINRA settlements are included). Pursuant to the settlements, ARSs investors, including retail customers, small businesses, and charitable organizations, will have the opportunity to receive 100 cents on the dollar on their investments within short time frames. Indeed, I understand that many of these investors already have accepted these offers and received the full par value of their investments. The settlements are the largest in the history of the SEC, and the relief provided by these settlements is unprecedented in type, magnitude and timing. These efforts have significantly reduced the total amount of frozen ARS and led to an increase in liquidity in the ARS market.

Enforcement continues to investigate other firms and individuals in this area.

Question 8

As this Congress moves forward with the modernization of our financial system, what changes does the SEC propose to ensure such a collapse does not occur again in the auction rate security market?

Our initiatives in the ARS market have focused on addressing the problems associated with the February 2008 collapse and helping investors exit the market. New initiatives introduced in the aftermath of the ARS dislocations should help not only existing ARS investors but also municipal market investors generally. For example, the Municipal Securities Rulemaking Board (MSRB) recently established a free, Internet-based system called EMMA (Electronic Municipal Market Access). EMMA is designed for use by investors who wish to obtain information regarding municipal securities at no charge, and by issuers and dealers to submit information to the Board. It is located at www.emma.msrb.org. EMMA includes information regarding municipal ARSs and variable rate demand obligations (VRDOs). The first phase, which includes information regarding the current interest rates for ARSs and certain related information, such as the maximum and minimum permitted rates, interest rate period, and maturity date, is now available on EMMA. The MSRB plans, subject to SEC approval, to add further information regarding ARSs and VRDOs. The "primary market" component of EMMA began June 1, 2009. The continuing disclosure component commenced July 1, 2009. The greater availability of disclosure documents and pricing information about municipal securities at no charge to investors and market participants should help assure that municipal market investors understand more fully the terms and risks of securities that they purchase, including municipal ARSs and the liquidity risks associated with them. Greater price transparency could also improve the liquidity of the markets and help existing ARS investors exit their positions.

July 14, 2009 Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises hearing entitled "SEC Oversight: Current State and Agenda"

Questions for Record from Congressman Sherman

Question 1
How much total Fair Fund compensation has the SEC authorized since the program's inception? Through how many funds? How much money has been distributed and how much remains to be distributed?

The Sarbanes-Oxley Act of 2002 gave the Commission authority to increase the amount of money returned to injured investors by allowing civil penalties to be included in Fair Fund distributions. Prior to Sarbanes-Oxley, only disgorgement could be returned to investors. Since 2002, the Commission has authorized approximately 300 Fair Funds and disgorgement funds, with an estimated total value of more than $10.6 billion. Since passage of Sarbanes-Oxley, an estimated $7.1 billion, approximately 67% of the total collected, has been returned to injured investors. As of December 2009, approximately $3.9 billion is available for distribution in approximately 200 active distribution matters. This amount, of course, will vary over time as new distribution funds are authorized and older funds are distributed to investors.

Question 2
Victims of financial fraud need all the help they can get. Given the extraordinary economic challenges the country and taxpayers are facing, why has more of the money in the Fair Funds not been distributed?

One of the top priorities for the Commission is the return of monies to harmed investors under the Fair Funds provisions of the Sarbanes-Oxley Act of 2002. During FY 2009, the Commission already has distributed over $2.1 billion from 36 separate funds, a two-fold increase in comparison with last fiscal year.

The staff currently is working diligently to advance approximately 200 distribution funds (arising both from both civil and administrative actions) that are in various stages of the distributions timeline. While each fund has its own unique set of facts and circumstances that may present obstacles to expeditious distribution, we have addressed, and continue to address, a wide-range of legal and practical issues tied to the size and complexity of these matters. For example:

- An unanticipated Fair Fund issue that arose involved the tax consequences of distributing penalties in addition to disgorgement. To resolve this issue, we were required to obtain nineteen IRS Private Letter Rulings indicating that civil penalties could be treated as a return of investor losses rather than as taxable amounts for purposes of these distributions.

- Similarly, for a number of our distributions, we were required to obtain a Department of Labor Field Assistance Bulletin to clarify that fund administrators were not fiduciaries under ERISA when making distributions directly to certain retirement accounts, and to define a safe harbor for plan fiduciaries who distribute funds in accordance with SEC distribution plans.

- More recently, in light of the current economic crisis, concerns have been raised about the safety of funds pending distribution. Although distribution funds typically are held in the SEC's Treasury accounts or court registries, fund administrators must take limited control of the funds in order to ultimately effectuate distributions to injured investors. After consulting with the FDIC, we addressed the identified risks.

- Because the harm to investors in certain cases (such as the mutual fund market timing matters) is not transparent, there has been an on-going need to ensure that the methodology for determining losses is correct in each case.

- In civil actions, plans may be opposed prior to approval. In the WorldCom litigation, for example, plan objections delayed adoption of the plan for over two years, with the matter finally being resolved by the Court of Appeals for the 2nd Circuit.

Obstacles continue to arise even after plan approval. For example:

- Obtaining investor information from financial intermediaries has posed challenges because the necessary information is not maintained uniformly throughout the industry. The lack of readily accessible information therefore delays the calculation of each investor's share of the fund and the preparation of investor payment files.

- Claims-made plans can be delayed by the need to respond to objections and appeals made by interested investors to determine whether they are eligible for a distribution pursuant to the terms of the approved plan (in Royal Dutch Shell, the court must resolve over 500 appeals).

- Ironically, staff has had to develop special procedures for publication of orders of disbursement so that large distributions to harmed mutual funds will not themselves create market timing opportunities.

In short, we are fully cognizant of the great need to distribute funds to harmed investors as quickly as possible, and are working diligently in an effort to bring this about.

Question 3

What is the SEC's process for administering Fair Funds? Are Fair Fund administrators selected at the headquarters level or are administrators selected by SEC Regional offices in the Region in which a fund is located?

The Division of Enforcement senior staff may on occasion act as administrators under plans of distribution in either administrative proceedings or district court proceedings. In more complex cases, or where a large number of investors may be expected to receive a payment, it is often preferable to seek appointment of a third party to perform the functions of administrator. In terms of the process for selecting third parties to perform administrative duties, the Division makes recommendations to courts or the Commission concerning the special appointment of persons to serve in a variety of capacities. These include (i) receivers in civil actions; (ii) fund administrators; and (iii) independent distribution consultants.

Receivers and fund administrators oversee the distribution of funds to investors by identifying investors, conducting the claims process, and effectuating the distribution (either electronically or by check) to injured investors. In addition, receivers are authorized by the courts to marshal assets and operate businesses. Receivers and fund administrators, once appointed, may employ other third-party agents to assist them in their duties. Staff may also seek appointment of an independent distribution consultant to assist the staff or the fund administrator in developing and implementing distribution plans in complex cases.

A three-person committee comprised of an Associate Director from the office responsible for the case, the SEC Home Office Chief or Deputy Chief Litigation Counsel, and the attorney in charge of the matter reviews the proposals and decides which applicant should be recommended to the court or Commission. The court or the Commission, depending on the whether the matter is a civil or administrative proceeding, makes the appointment after considering the Division's recommendation.

In addition, in March 2009, the staff published a Distributions Manual to provide guidance to staff on the procedures for developing and administering plans to distribute disgorgement and Fair Funds to injured investors. The new manual, which provides step-by-step instructions for distribution plans in both civil actions and administrative proceedings, enables Division staff to advance the distribution process more quickly. In addition, the Division made collections and distributions information more accessible to the staff by centralizing it on the Division's internal website.

Question 4
Are there any standardized SEC protocols used to qualify firms to administer the settlement distribution process? Would adoption of such protocols speed up the settlement proceeds distribution process? Do you have other suggestions?

In civil proceedings, Division protocol is to ask the court if it wants the SEC staff to recommend a receiver or fund administrator. If the court requests a recommendation, and in administrative proceedings, unless otherwise ordered by the Commission, the SEC staff proposes a candidate selected through the following procedures. The SEC staff solicits written proposals from at least three qualified persons seeking a resume, a description of the hourly rates for each professional who will work on the matter, a description of the discount, if any, from the candidate's usual rates, a general description of the steps the candidate would propose to perform the assignment, how the candidate would staff tasks, whether the candidate has any conflicts, an agreement to disclose any conflicts that may arise during the engagement; and any other information deemed pertinent to the engagement. Candidates agree to report periodic expenses on a standardized fund accounting report and, in the case of receivership appointments, must agree to abide by the specific billing instructions intended to manage costs. Before making a recommendation, the committee attempts to determine if a proposed candidate has served in another SEC matter and speaks with the relevant staff about the person's qualifications. In each instance, our goal is to make a recommendation in an expeditious fashion that will be consistent with the public interest and the protection of investors. We believe these procedures further that goal.

Question 5
How can the Fair Fund settlement proceeds distribution process be improved?

We are examining ways of making the distribution process more timely and cost-effective. Among other things, the management of the Commission's Office of Collections and Distributions is now centralized within the Division of Enforcement and headed by the Division's Managing Executive. In the coming months, we expect that the Division will make recommendations to the Commission aimed at making the distribution process more efficient and effective in returning funds to injured investors.

As we seek to continue to improve efficiencies and streamline our distribution processes, it is clear that our ability to do so will be dependant in part on additional resources.

Increased Human Capital Resources: The Division's efforts to streamline its programs and concentrate the maximum level of its staff resources on critical investigative work highlight the significant challenges we face in providing sufficient staffing for the program area of effective and timely funds distribution. Additional attorneys, paralegals and support staff dedicated to this area are critical to continued centralization and increased efficiency in this area.

Technological Resource Constraints: The Division has prepared business requirements for improved recording and monitoring of distribution-related information. While significant technological development has occurred, finalizing and rolling out enhanced functionality will depend upon the availability of additional funding.

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