

**Testimony on Budget and Management of the U.S. Securities and Exchange Commission**

**By**

**Robert Khuzami, Director, Division of Enforcement**  
**Meredith Cross, Director, Division of Corporation Finance**  
**Robert Cook, Director, Division of Trading and Markets**  
**Carlo di Florio, Director, Office of Compliance Inspections and Examinations**  
**Eileen Rominger, Director, Division of Investment Management**  
*U.S. Securities and Exchange Commission*

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

**Thursday, March 10, 2011**

Chairman Garrett, Ranking Member Waters, Members of the Subcommittee:

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

As Directors of five major divisions and offices of the SEC, each of us came to the agency within the past two years dedicated to furthering the Commission's vital mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation. We appreciate the opportunity to discuss the President's FY 2012 budget request for the Commission, as well as to report on the broad responsibilities performed by the SEC, the recent reforms we have undertaken, and the challenges that lie ahead.

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

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

**Current Challenges**

FY 2011 and FY 2012 mark a critical period for the agency. Not only does the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") create significant additional mandates for the SEC, both in the short and long term, but the agency must continue to carry out

its longstanding core responsibilities. These responsibilities — pursuing securities fraud, reviewing public company disclosures and financial statements, inspecting the activities of investment advisers, investment companies, broker-dealers and other registered entities, and maintaining fair and efficient markets — remain essential ingredients to restoring investor confidence and trust in financial institutions and markets following the recent financial crisis.

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

As a result of increased funding levels in FY 2009 and FY 2010, current SEC staffing levels are just now returning to the level of FY 2005, despite the enormous growth in the size and complexity of the securities markets since then. During the past decade, for example, trading volume has more than doubled, the number of investment advisers has grown by 50 percent, and the assets they manage have increased to \$38 trillion. A number of financial firms spend many times more each year on their technology budgets alone than the SEC spends on all of its operations. Six years ago, the level of SEC funding was sufficient to provide 19 examiners for each trillion dollars in assets under management by investment advisers. Today, that figure stands at 12 examiners per trillion dollars.

Today, the SEC has responsibility for approximately 35,000 entities, including oversight of 11,800 investment advisers, 7,500 mutual funds, and more than 5,000 broker-dealers with more than 160,000 branch offices. We also review the disclosures and financial statements of nearly 10,000 reporting companies. The SEC also oversees approximately 500 transfer agents, 15 national securities exchanges, 9 clearing agencies, 10 nationally recognized statistical ratings organizations (NRSROs), as well as the Public Company Accounting Oversight Board (PCAOB), Financial Industry Regulatory Authority (FINRA), Municipal Securities Rulemaking Board (MSRB), and the Securities Investor Protection Corporation (SIPC). In addition, the Enforcement Division has jurisdiction over any person or entity that violates the securities laws, regardless of whether they are associated with one of these 35,000 entities.

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

In acknowledgement of this significant new workload, the Dodd-Frank Act authorized an increase in the agency's budget from the \$1.11 billion appropriated in FY 2010 to \$1.3 billion in FY 2011, \$1.5 billion in FY 2012, and \$2.25 billion by FY 2015.

So far, the SEC has proceeded with the first stages of implementation of the Dodd-Frank Act without additional funding. This largely has involved performing studies, analyses, and the writing of rules. These initial tasks have taken staff time away from other responsibilities, but we have carried them out almost entirely with existing staff. It is the next step of making the new oversight regimes operational that will require significant additional resources.

### **FY 2012 Budget Request**

The SEC is requesting \$1.407 billion for FY 2012.<sup>1</sup> This represents an increase of \$264 million over the agency's current FY 2011 spending authority, and will support 4,827 positions (4,460 full-time equivalents, or FTE), an increase of 780 positions (612 FTE) over projected FY 2011 levels. The FY 2012 request is designed to provide the SEC with the resources required to achieve multiple, high-priority goals: adequately staffing the agency to fulfill its core mission of protecting investors, maintaining fair, orderly and efficient markets, and facilitating capital formation; continuing to implement the Dodd-Frank Act; and expanding the agency's information technology (IT) systems and management infrastructure to serve the needs of a more modern and complex organization.

It is important to note that the SEC's FY 2012 funding request will be fully offset by matching collections of fees on securities transactions. Currently, the transaction fees collected by the SEC are approximately two cents per \$1,000 of transactions. Under the Dodd-Frank Act, beginning with FY 2012, the SEC is required to adjust fee rates so that the amount collected will match the total amount appropriated for the agency by Congress. Under this mechanism, SEC funding will be deficit-neutral, as any increase or decrease in the SEC's budget would result in a corresponding rise or fall in offsetting fee collections from market participants.

Of the new positions requested for FY 2012, 312 positions (40 percent) will be used to strengthen and support core SEC operations and to continue reforming its operations and fostering stronger protections for investors. The other 468 positions (60 percent) of the new positions requested for FY 2012 are necessary initially to implement the Dodd-Frank Act. The agency also will need to invest in technology to facilitate the registration of additional entities and capture and analyze data on the new markets. The cost of these new positions and technology investments to implement the Dodd-Frank Act will be approximately \$123 million. Many of these new positions will be for experts in derivatives, hedge funds, data analytics, credit ratings, and other new or expanded responsibility areas. The new positions will support important new responsibilities including:

- **Derivatives** -- 157 positions focused on the derivatives markets, including 47 staff in the Division of Trading and Markets to develop programs to oversee over-the-counter derivatives, 34 examination staff to inspect for compliance, and 43 enforcement staff.

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<sup>1</sup> In accordance with past practice, the budget justification of the agency was submitted by the Chairman of the Commission and was not voted on by the full Commission.

- **Hedge Funds** -- 102 positions focused on compliance with the new rules for private fund advisers, including 45 examination staff, 21 enforcement staff, and 15 assigned to the Divisions of Investment Management and Risk, Strategy, and Financial Innovation.
- **Oversight** -- 50 positions to support implementation of various requirements with respect to investment advisers and broker-dealers (16 positions), review of self-regulatory organization (SRO) rule filings (11 positions), PCAOB oversight (9 positions), asset-backed securities (8 positions), and corporate governance disclosure and procedural matters (6 positions).
- **Whistleblower** -- 43 positions to support the whistleblower program, including expanding intelligence and investigative analyses of tips received from whistleblowers, and conducting resulting investigations.
- **Municipal Securities** -- 35 positions focused on municipal securities, principally to conduct examinations of newly-registered municipal advisors and to build the new Office of Municipal Securities required under the Dodd-Frank Act.
- **Clearing** -- 33 positions focused on the Act's new responsibilities with respect to clearing, including annual reviews of systemically important agencies, including 20 examination staff and 12 staff in the Division of Trading and Markets.
- **Credit Rating Agencies** -- 26 positions focused on NSRSOs, principally for the Office of Credit Ratings to perform the annual examinations required by the Dodd-Frank Act.

In addition to the new positions requested in FY 2012, the SEC also anticipates that an additional 296 positions will be required in FY 2013 for full implementation of the Dodd-Frank Act.

### **Investing in Information Technology**

The SEC's budget request for FY 2012 will support information technology investments of \$78 million, an increase of \$23 million over FY 2011. This level of funding would support vital new technology initiatives including data management and integration, document management, EDGAR modernization, market data, internal accounting and financial reporting, infrastructure functions, and improved project management. This funding will permit the agency to develop risk analysis tools to assist with triage and analysis of tips, complaints, and referrals and to complete a digital forensics lab that enforcement staff can use to recreate data from computer hard drives and cell phones to capture evidence of sophisticated frauds. The budget request would also permit the hiring of additional staff in the Office of Information Technology, including experienced business analysts and certified project managers to oversee IT projects and staff to address financial statement and information technology deficiencies identified by the Government Accountability Office (GAO).

### **Addressing Material Weaknesses in Internal Controls**

In November 2010, the SEC completed its Performance and Accountability Report, the equivalent of a company's annual report. A GAO audit found that the financial statements and notes included in the report were presented fairly and in conformity with U.S. GAAP. It also, however, identified two material weaknesses in internal controls over financial reporting: one in information systems, and a second in financial reporting and accounting processes. The root

causes of these weaknesses are gaps in the security and functionality of the agency's financial system, resulting from years of underinvesting in financial system technologies.

These material weaknesses are unacceptable. Rather than try and solve each particular deficiency in piecemeal fashion, the agency has committed to investing the time and resources to implement a long-term, comprehensive solution. To avoid the development risks of creating new technology and systems, the SEC is switching to a Shared Service Provider approach, migrating the agency's financial system to the Department of Transportation. Other agencies, including GAO, have migrated to DoT, and they have had very positive results, with clean audits free of material weaknesses. This will be a significant undertaking, which, assuming adequate funding, will culminate in the cutover to the new system in April 2012.

## **DIVISION OF ENFORCEMENT**

Director, Robert Khuzami<sup>2</sup>

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

### **Structural Reforms**

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

***Specialization.*** The introduction of five new national specialized investigative units dedicated to high-priority areas of enforcement which consist of: Asset Management (hedge funds and investment advisers), Market Abuse (high-volume and computer-driven trading strategies, large-scale insider trading, and market manipulation schemes), Structured and New Products (various derivative products), Foreign Corrupt Practices Act violations, and Municipal Securities and Public Pensions. The specialized units, as well as various specialization initiatives in our regional offices, are utilizing enhanced training, specialized industry experience and skills, and targeted investigative approaches to better detect links and patterns suggesting wrongdoing — and ultimately to conduct more efficient and effective investigations. In order to conduct effective investigations in our high-priority areas, prior to the Continuing Resolution, each of the specialized units had been in the process of hiring additional professionals with specialized experience such as trading strategies and trading abuse specialists, quantitative analysts, data architects, market structure experts, portfolio managers, private equity analysts, equity traders,

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<sup>2</sup> Mr. Khuzami joined the SEC as Director of Enforcement in March 2009.  
<http://www.sec.gov/news/press/2009/2009-31.htm>

and individuals with experience in structuring complex financial instruments and rating structured deals. In addition to investigative work, the specialized units are engaged in a number of initiatives with our colleagues in the Office of Compliance Inspections and Examinations (OCIE) and other divisions to develop risk analytics that proactively identify high-risk areas for further examination and investigation.

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

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

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

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

***Elimination of Unnecessary Process.*** We improved our law enforcement capabilities and sent a clear signal internally and externally that we value toughness and speed. For example, the Commission delegated to senior staff the authority to initiate formal investigations and issue subpoenas without the prior approval of the Commission. We also have eliminated approvals for

certain routine settlement discussions, Wells notices and the opening of initial matters under investigation. Proper levels of supervision and oversight remain across all of these areas.

***Whistleblower Office.*** The Dodd-Frank Act substantially expands the agency’s authority to compensate individuals who provide the SEC with useful information about violations of the federal securities laws. Last November, the Commission proposed rules mapping out the procedure for would-be whistleblowers to provide critical information to the agency. The proposed rules set forth how eligible whistleblowers can qualify for an award through a transparent process that provides them an opportunity to assert their claim to an award. Recently, we announced the selection of a Whistleblower Coordinator to oversee the whistleblower program. We also have fully funded, with the proceeds of penalty amounts, the SEC Investor Protection Fund, which will be used to pay awards to qualifying whistleblowers. Pending the adoption of final rules, Enforcement staff has been reviewing and tracking whistleblower complaints submitted to the Commission.

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

## **Effective Results**

Although statistics alone cannot capture the breadth of the Division’s work, since undertaking these reforms, the SEC’s enforcement activity has increased significantly. For example, in each of the past two fiscal years, we have filed more enforcement actions than in the previous fiscal year. Our 2010 enforcement actions resulted in approximately \$2.85 billion in ordered disgorgement and penalties – over a 176 percent increase from amounts ordered in 2008. In fiscal year 2010 we successfully sought emergency relief from federal courts in the form of temporary restraining orders to halt ongoing misconduct and prevent imminent investor harm in 37 actions; obtained 57 asset freezes to preserve funds for the benefit of investors; and distributed to injured investors nearly \$2.0 billion from 42 separate Fair Funds. In addition, our actions halted trading in the securities of 254 issuers that we alleged had inadequate public disclosures – an increase of over 34 percent as compared to fiscal year 2008.

During the past year, the Commission brought significant actions involving issues arising from the financial crisis, including actions against the former CEO and other executives of Countrywide Financial, Citigroup and its former CFO and Head of Investor Relations, Morgan Keegan, Goldman Sachs, State Street Bank, former executives of New Century Financial and IndyMac Bancorp, Brookstreet Securities, and ICP Asset Management and its President. We’ve obtained multi-million dollar settlements with Tyson Foods, Alcatel-Lucent, Technip, and General Electric for violations of the Foreign Corrupt Practices Act (FCPA). We filed our first case against a state involving municipal securities. We brought accounting fraud cases against Dell, Diebold, and DHB Industries. We brought a significant case charging inappropriate use of confidential customer information by a proprietary trading desk at Merrill Lynch and an action

against AXA Rosenberg in the challenging and rapidly evolving area of computer-based quantitative investment management. We filed a variety of cases to halt Ponzi scheme operators and perpetrators of offering frauds, including those brought in conjunction with the Financial Fraud Enforcement Task Force's Operation Broken Trust sweep. More recently, we brought cases alleging illegal trading on confidential information obtained from technology company employees moonlighting as expert network consultants, illegal trading by major hedge funds based on illegal tips, and a \$1.5 billion mortgage securities fraud scheme to defraud the U.S. Treasury's Troubled Asset Relief Program (TARP).

### **Upcoming Challenges**

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

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

### **CORPORATION FINANCE**

Director, Meredith Cross<sup>3</sup>

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

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<sup>3</sup> Ms. Cross joined the SEC as Director of Corporation Finance in June 2009.  
<http://www.sec.gov/news/press/2009/2009-78.htm>



## **CF's Core Functions**

Generally, CF reviews company filings, makes rulemaking recommendations to the Commission, and provides interpretive advice to market participants and the public about the securities laws and corresponding regulations. The Division recently made some targeted changes to its operations, creating a new deputy director for policy and capital markets position, and adding three new offices – the Office of Structured Finance, which will help us address complexities and change in the asset-backed securities market; the Office of Capital Markets Trends, which will evaluate trends in securities offerings and in our capital markets to determine if our rules, regulations, and review approach are adequately addressing them; and finally, a new review group in disclosure operations that will focus on the largest financial institutions. While the Division has established these offices and will transfer some existing staff to them, hiring to fully staff these offices has been deferred until funding has been resolved.

### **Review of Filings**

CF selectively reviews filings of new issuers and public companies reporting under the 1934 Act to both monitor and enhance compliance with disclosure and accounting requirements. The staff members engaged in filing reviews have specialized industry, accounting, and disclosure expertise. Approximately 80 percent of the staff of the Division is assigned to the disclosure review program. The Sarbanes-Oxley Act requires the Division to review the financial statements of all companies reporting under the 1934 Act at least once every three years and more frequently where circumstances warrant. The staff may review more than one disclosure document from the same company in a single fiscal year. For example, the staff is currently conducting “real-time” continuous reviews of filings made by the largest financial institutions.

In the course of a review, the staff may issue comments to a company to elicit better compliance with applicable disclosure requirements. In response to those comments, a company may need to revise its financial statements or amend its disclosure to provide additional or enhanced information, or may undertake to revise its financial statements or other disclosures in future filings. Where appropriate, CF refers matters to the Division of Enforcement.

CF currently plans to enhance the full disclosure program to improve the Division's role in promoting full, fair, and timely disclosure of information for investors. The Division intends to implement these plans in FY 2011 and FY 2012 and will broaden the scope of review and increase its focus on large and financially significant registrants. However, the ability to implement these enhancements turns on whether we are able to allocate sufficient resources, balancing all other demands on the Division and our limited staff.

Smaller reporting companies – generally, those with a public float less than \$75 million – comprise close to half of the public companies filing with the SEC, yet their aggregate market capitalization is less than one percent of the total market capitalization of all reporting companies that the Division reviews. While these companies, and investors making decisions about them, may particularly benefit from SEC staff review, in light of resource constraints and the relatively small market capitalization of these issuers, the Division plans to evaluate the application of the review program to smaller companies to assess whether the nature of the reviews may be scaled

back, while still satisfying the Sarbanes-Oxley Act mandate to review the financial statements of all public companies at least once every three years.

### **Interpretive Advice**

CF provides advice to market participants and the public through interpretive releases, staff legal and accounting bulletins, updates to the Division's financial reporting manual, no-action and interpretive letters, issuance of compliance and disclosure interpretations on the Division's section of the Commission's Web site, and responses to telephone and e-mail inquiries. In FY 2011 and FY 2012, CF expects its workload in this area may increase beyond that of recent years due to the Commission's adoption and implementation of rules required by the Dodd-Frank Act and, to a lesser extent, rules relating to shareholder director nominations.

### **Rulewriting**

CF also makes rule recommendations to the Commission as needed to improve investor protection, facilitate capital formation, and enhance disclosure. The Division expects to recommend changes to existing rules in a number of areas in FY 2011 and FY 2012, including:

- **Core disclosure requirements.** The Division intends to review and recommend amendments to modify core disclosure requirements, many of which have not been significantly updated in close to 30 years, to ensure that they reflect contemporary business practices and address the needs of modern day investors. The goal is to make sure that the rules elicit useful information, not necessarily more information. In determining what information is useful to today's investors, the Division expects to conduct roundtables and other direct contact with professional and non-professional investors. CF expects this project will be accomplished in phases over several years. As part of this project, CF will work with the Commission's Office of Information Technology to consider how disclosure documents are electronically prepared and submitted to the agency, and how they appear on EDGAR.
- **Small business initiatives.** The Division will consider the recommendations of the Government Business Forum on Small Business Capital Formation and ideas from other sources in developing recommendations for the Commission's consideration to facilitate small business capital formation.
- **Credit rating shopping.** The Division will consider recommending that the Commission adopt rules requiring disclosure of credit rating information, including disclosure relating to credit rating shopping.
- **Improvements to proxy voting and shareholder communications processes.** The Division is reviewing public comment on the Commission's concept release regarding proxy voting and shareholder communications. CF staff will work closely with other SEC divisions and offices with regard to possible recommendations to the Commission for proposed rule amendments to address areas that may be in need of improvement.
- **Rules concerning beneficial ownership reporting.** CF continues to evaluate developments with respect to beneficial ownership reporting by investors and is

considering recommendations for the Commission concerning changes in the disclosure obligations of investors relating to the use of derivative instruments and short positions, as well as the timing of the reporting requirements.

### **Enforcement Liaison**

The Division regularly provides technical assistance to the Division of Enforcement on enforcement matters. In 2010 fiscal year, CF responded to over 1575 inquiries from that Division, and we have as of the end of February, addressed at least 817 such inquiries this year. In fiscal year 2010, we referred 309 matters to Enforcement and as of the end of February we have sent 148 matters to Enforcement so far this fiscal year.

### **International Coordination**

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

### **Dodd-Frank Rulewriting**

In addition to the rulemaking initiatives discussed above, CF staff is responsible for preparing rules to implement a significant number of Dodd-Frank Act requirements. CF has reassigned a number of attorneys from throughout the Division, including disclosure operations, to work on these rules. CF expects that these projects will be conducted throughout FY 2011 and FY 2012.

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

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

- **Representations and Warranties.** On January 20, 2011, the Commission adopted final rules to implement Section 943 of the Dodd-Frank Act, which requires the Commission to adopt rules regarding representations and warranties in ABS.
- **Issuer Review of Underlying Assets.** On January 20, 2011, the Commission adopted final rules to implement Section 945 of the Dodd-Frank Act. Section 945 requires the Commission to issue rules requiring an asset-backed issuer in a 1933 Act registered transaction to perform a review of the assets underlying the ABS, and disclose the nature of such review.

- **Risk Retention.** CF staff is working closely with other regulators to jointly develop recommendations to implement the risk retention rules required by Section 941 of the Dodd-Frank Act. These rules will address the appropriate amount, form, and duration of required risk retention for ABS securitizers, and the definition of qualified residential mortgages.

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

- **“Say-on-Pay” and “Golden Parachute.”** In January 2011, the Commission adopted rules to implement the provisions of the Dodd-Frank Act that require public companies subject to the federal proxy rules to provide their shareholders with:
  - an advisory vote on executive compensation, generally known as “say-on-pay” votes, as well as with an advisory vote on the desired frequency of say-on-pay votes.
  - an advisory vote on compensation arrangements and understandings in connection with merger transactions, known as “golden parachute” arrangements.
- **Compensation Committees and Compensation Consultants.** The Commission is required by Section 952 of the Dodd-Frank Act to mandate new listing standards relating to the independence of compensation committees and to establish new disclosure requirements and conflict of interest standards that boards must observe when retaining compensation consultants.
- **Recovery of Erroneously Awarded Compensation.** Section 954 of the Dodd-Frank Act requires the Commission to adopt rules mandating new listing standards relating to specified executive compensation “clawback” policies.
- **Pay versus Performance and Pay Ratios.** Under Section 953 of the Dodd-Frank Act, the Commission must adopt rules requiring new disclosures about the relationship between executive compensation and company performance, and the ratio between the median of the annual total compensation of an issuer’s employees and the annual total compensation of the issuer’s chief executive officer.
- **Employee and Director Hedging.** Section 955 of the Dodd-Frank Act requires the Commission to adopt rules requiring disclosure by issuers of their policies relating to certain employee and director hedging activities.

**Specialized Disclosures.** Title XV of the Dodd-Frank Act contains specialized disclosure provisions related to conflict minerals, coal or other mine safety, and payments by resource extraction issuers to foreign or U.S. government entities. The Commission published the rule proposals relating to these three provisions in December 2010. The comment periods were scheduled to close on January 31, 2011, but the Commission extended the comment periods for all three rule proposals for 30 days, to March 2, 2011 after receiving several requests for an extension of the time for public comment.

### *Exempt Offerings.*

- **Accredited Investor.** Section 413(a) of the Dodd-Frank Act requires the definition of “accredited investor” in the Commission’s 1933 Act rules to exclude the value of a person’s primary residence for purposes of determining accredited investor status on the basis of having net worth in excess of \$1 million. The Commission proposed rule amendments on January 25, 2011 that would implement this provision, and would clarify the treatment of any indebtedness secured by the residence in the net worth calculation.
- **“Felons and Other ‘Bad Actors’”.** Under Section 926 of the Act, the Commission is required to adopt rules that disqualify securities offerings involving certain “felons and other ‘bad actors’” from relying on the safe harbor from 1933 Act registration provided by Rule 506 of Regulation D.

### **Upcoming Challenges**

While CF has developed review practices and procedures to satisfy the Sarbanes-Oxley Act mandate to review the financial statements of all reporting companies at least once every three years, this requirement, coupled with limited resources, constrains the Division’s ability to devote sufficient resources to the review of companies that represent the largest portion of U.S. market capitalization. The Division’s limited staff is responsible for reviewing the disclosures of approximately 10,000 reporting companies under this review mandate, and also for reviewing registration statements and other transactional filings made under the 1933 Act and 1934 Act, such as filings related to capital raising and business combinations. The challenges of staffing the review program are even greater in light of the Division’s new responsibilities under the Dodd-Frank Act. As noted, CF is currently evaluating its review program with the goal of increasing its focus on large and financially significant registrants and assessing whether additional efficiencies might be gained with regard to its reviews of smaller reporting companies, consistent with its obligations under the Sarbanes-Oxley Act. CF has already made targeted changes to its operations, including the formation of three new offices in order to better fulfill our mission of investor protection. The ability to realize these benefits will be compromised, however, if we are unable to fully staff them and/or are unable to hire staff with the necessary expertise in structured products or in the capital markets.

## **TRADING AND MARKETS**

Director, Robert Cook<sup>4</sup>

The Division of Trading and Markets (TM) is responsible for establishing and maintaining standards for fair, orderly, and efficient markets. While TM’s workload continues to be dominated by a diverse range of core functions that are vital for protecting investors and markets, the scope of its responsibilities has expanded tremendously under the Dodd-Frank Act.

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<sup>4</sup> Mr. Cook joined the SEC as the Director of Trading and Markets in January 2010.  
<http://www.sec.gov/news/press/2009/2009-242.htm>

## **TM's Core Functions**

### **Oversight of Securities Markets**

TM devotes substantial resources to regulating the securities markets, including 15 securities exchanges (equities and options), 3 electronic communication networks (ECNs), over 60 active alternative trading systems, and over 200 internalizing broker-dealers. Our ongoing oversight responsibilities include:

- Reviewing new exchange registrations, an extensive process that requires analysis of, among other complex issues, the impact of a new exchange on the protection of investors, the public interest, and the national market system. TM currently estimates receiving applications for four to eight new exchanges through FY 2012.
- Processing proposed SRO rule changes, which address issues ranging from new fee structures to changes in trading rules to revamped governance structures. TM received over 2,000 rule filings in 2010, nearly double the number of filings received only five years ago.<sup>5</sup>
- Reviewing new financial products, ranging from now-common index exchange traded funds (ETFs) to physical commodity trusts to more esoteric products.
- Initiating changes to market rules to keep pace with market developments.

The Division also leads Commission efforts to respond to significant market events, such as the severe market disruption of May 6, 2010. In addition to spearheading the Commission's inquiry into that day's events, coordinating an independent joint SEC-CFTC advisory committee focusing on those events, and publishing two joint reports with the staff of the CFTC, the Division led the implementation of key regulatory responses, including: (1) a uniform circuit breaker pilot program designed to halt trading in a disorderly market; (2) pilot exchange rules designed to improve the process of breaking "clearly erroneous" trades; and (3) exchange rules to enhance quotation standards for market makers.

***Key Challenges.*** The Division's mission has become ever more challenging with the exponential growth in the size and complexity of the U.S. securities markets.

- ***Rapidly changing markets.*** Markets today are vastly different from markets even five years ago: there are more trades occurring in smaller average sizes on an increasing number of trading venues. For example, the total volume of trading in exchange-listed stocks grew 107 percent in the last six years, reaching an average daily volume of 8.5 billion shares in 2010. In 2005, there were 2.9 million average daily trades in NYSE-listed stocks, and 79 percent of the volume in such stocks was executed on the NYSE. In 2010, average daily trades in these stocks had increased by 486 percent, to 17 million, but the NYSE's percentage had fallen to roughly 22 percent by January 2011. The remaining volume had shifted to a number of diverse trading venues. Options markets have experienced similar dynamic growth as total contract volume of trading in equity options grew 264 percent in the last six years. Volume in equity options also is dispersed across an increasing number of options exchanges, as evidenced by the dispersed market share

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<sup>5</sup> This number includes filings by the exchanges and other SROs, such as clearing agencies, FINRA, and the MSRB.

for 2010 total contract volume, where 5 out of 9 options exchanges each had between a 10 percent and 25 percent market share.

- *Expanding information and surveillance gaps.* This tremendous increase in volume generates significant amounts of trading information. However, the Division's ability to obtain relevant information in a timely manner – and to use it to monitor markets effectively or to respond rapidly to crises such as May 6 – is limited by the lack of any standardized, automated system to collect data in real time or close to real time across the various trading venues, products, and market participants. For example, to obtain individual trader information the Commission must make a series of time-consuming manual requests. The Commission's tools for collecting data and overseeing markets do not even incorporate readily available technology currently used by those the Commission regulates.

**Core Initiatives.** In FY 2011 and FY 2012, the Division plans to focus on several key initiatives to improve market oversight:

- *Advancing a comprehensive review of equity market structure.* In January 2010, the SEC published a concept release on equity market structure in order to solicit public input on several of the key issues highlighted by the explosive growth in trading volume: (1) the quality of performance of the current market structure; (2) high frequency trading; and (3) undisplayed liquidity in all its forms. In addition to considering the more than 200 comment letters that the Commission received, the Division organized a Commission-hosted public roundtable on market structure in June 2010. The Division plans to continue to advance this discussion and consider appropriate rulemaking responses in the coming months.
- *Enhancing market surveillance.* In spring 2010, the Commission published for comment TM proposals to require large trader reporting and to mandate the development and implementation of a consolidated audit trail system. The Division plans to continue work on these proposals and other mechanisms to enhance market surveillance in FY 2011 and FY 2012.
- *Addressing, as appropriate, significant market developments.* The Division plans to continue to identify and, as appropriate, formulate rules to respond to, significant equities and options market developments in FY 2011 and FY 2012, which will include the evolution of the single-stock circuit breaker into "limit-up/limit-down" functionality and the review of proposed exchange mergers or other business combinations.

### **Oversight of Clearing Agencies and Transfer Agents**

The Division currently participates in the oversight of 9 active clearing agencies that are examined by the Commission, and anticipates that a number of additional clearing agencies may become subject to Commission oversight in FY 2011 and FY 2012. The Division has significant ongoing oversight responsibilities with respect to clearing agencies, and our ability to develop and sustain our oversight functions depends on adequate staffing and resources. These responsibilities include:

- Reviewing new clearing agency registration applications and rule changes, a complex process that involves addressing key systems, operations, and risk management issues;

- Engaging in rulemaking, including adopting new prudential standards; and
- Monitoring risk-related issues as part of a recently developed Clearing Agency Monitoring group, which has been created to monitor and evaluate clearing agency risk management and operational systems.

In addition, the Division is responsible for rules relating to approximately 500 registered transfer agents. The Division is evaluating whether to make extensive recommendations to the Commission to modernize transfer agent regulation.

### **Oversight of Broker-Dealers, FINRA and SIPC**

***Broker-Dealers.*** The Division oversees regulations governing over 5,000 registered broker-dealers, including by:

- Establishing or approving rules governing broker-dealer activities, including rules pertaining to capital adequacy, the protection of customer assets, anti-money laundering, sales practices and record-keeping.
- Supervising on an ongoing basis the financial activities and risk-management controls of certain “risk-supervised broker-dealers,” and reviewing filings of other broker-dealers with respect to their material affiliates.

***FINRA Oversight and Coordination.*** The Division oversees FINRA by reviewing and processing its rule filings. TM also works closely with FINRA on various issues, including monitoring and responding to emerging regulatory issues relating to broker-dealers.

***SIPC Oversight.*** The Division supervises SIPC (in conjunction with OCIE) and monitors the liquidation of broker-dealers under the Securities Investor Protection Act of 1970 in order to help ensure that customers of failed firms are compensated to the fullest extent allowed by the law.

### **Oversight of Credit Rating Agencies**

TM currently writes rules applicable to the 10 credit rating agencies registered with the Commission as nationally recognized statistical rating organizations (NRSROs), reviews applications from potential new registrants and, in conjunction with OCIE, monitors their activities.

### **Oversight of Municipal Securities Market Participants and MSRB**

The Division currently administers the rules of the Commission with respect to the practices of municipal securities brokers and dealers and municipal advisors. It also reviews MSRB rulefilings, coordinates with the MSRB in rulemaking and enforcement actions, and, together with the Division of Corporation Finance, advises the Commission on policy matters relating to the municipal bond market.<sup>6</sup>

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<sup>6</sup> The Dodd-Frank Act envisions that certain of the credit rating agency and municipal securities functions currently being carried out by TM will eventually be folded into separate offices. In addition to the Whistleblower Office mentioned earlier, the Dodd-Frank Act requires the Commission to create four new offices within the Commission, specifically, the Office of Credit Ratings, Office of the Investor Advocate, Office of Minority and Women Inclusion,



### **Oversight of Trading Practices**

The Division develops rules and other initiatives that respond to the constant evolution in trading practices among market participants. Among other efforts, the Division leads and administers Commission initiatives with respect to: (1) secondary market activities related to the IPO market; (2) the regulation of research analysts, (3) short sale regulations; (4) securities lending; (5) over-the-counter (OTC) equities market activities; and (6) certain measures to prevent manipulative practices.

### **Continuity of Markets and Operations / Cyber Security**

TM is responsible for supervising the capacity and resilience of our largely electronic exchanges and responding to potential disruptions to market continuity, whether due to systems outages, geopolitical uncertainty, malicious systems intrusions, or other causes. In addition, the Division performs cyclical reviews of exchanges, ECNs, and clearing agencies to ensure they are acting in accordance with the Commission's Automation Review Policies (ARP) and have adequate systems in place to deal with technology disruptions. In 2010, TM conducted 12 such ARP reviews. In FY 2011 and FY 2012, the Division plans to enhance its ARP reviews, with a particular focus on whether registered entities have appropriate cyber security measures. The Division is also preparing recommendations for the Commission to further strengthen the ARP standards.

### **Enforcement Liaison**

The Division regularly provides technical assistance to the Division of Enforcement on enforcement matters. In 2010, TM responded to over 950 inquiries from that Division, and we are on track to address roughly 1,200 inquiries this year.

### **Investor / Market Participant Guidance**

The Division also responds to calls, emails, correspondence and other communications from industry, counsel, the public, congressional staff, foreign sources and others. Last year, the Division handled roughly 15,000 such communications and since last March has processed over 1,000 tips, complaints, referrals, and regulated entity notices. The Division also issues written interpretive guidance and no-action and exemptive relief to market participants.

### **International Coordination**

The globalization of securities markets requires TM to coordinate its regulatory activities with its foreign counterparts on an ongoing basis. The active participation of TM staff with technical expertise in international working groups – of, among others, the International Organization of Securities Commissions, the Financial Action Task Force, the Joint Forum and the Financial Stability Board – is essential to the fulfillment of the Commission's responsibilities. Such participation also helps ensure that international standards are consistent with Commission policy and in the interests of the United States.

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and Office of Municipal Securities. As each of these offices is statutorily required to report directly to the Chairman, the creation of these offices is subject to approval by the Commission's appropriations subcommittees to reprogram funds for this purpose. Until reprogramming approval is received, the initial functions of the offices are being performed on a limited basis by other divisions and offices.

## **Dodd-Frank-Related Challenges**

Many of these core functions have been substantially expanded by the mandates of the Dodd-Frank Act, including functions related to exchanges, clearing agencies, NRSROs, and municipal markets. In addition, TM has been charged with developing the registration and regulatory regime for entities that participate in the security-based OTC derivatives market. All told, the Division is responsible for over 25 separate rulemaking initiatives with adoption deadlines of one year or less under the Dodd-Frank Act. Many of these rulemakings are the first step in new ongoing supervisory and regulatory functions for TM that will extend into FY 2012 and beyond.

### **Regulation of OTC Derivatives**

***New Categories of Registrants.*** The Division will be responsible for the registration and other rules for four entirely new categories of entities: security-based swap execution facilities (SEFs) (an estimated 20 new registrants in FY 2011 and FY 2012); security-based swap data repositories (SDRs) (an estimated three new registrants in FY 2011 and FY 2012); security-based swap dealers (an estimated 50 new registrants in FY 2011 and FY 2012); and major security-based swap participants (an estimated fewer than 10 in FY 2011 and 2012).

***New Rules under Title VII.*** Title VII of the Dodd-Frank Act establishes a new oversight regime for the OTC derivatives market and requires the Commission to write rules that address, among other things: business conduct, capital, and margin requirements for market intermediaries; the operation of trade execution facilities and data repositories; mandatory clearing requirements; and public transparency for price and trade information. The Division has already prepared ten rulemaking proposals in this area that the Commission has published for comment, namely, proposed rules regarding:

- Anti-fraud and anti-manipulation measures regarding security-based swaps;
- Reporting and real-time public dissemination of trade information for security-based swaps;
- Obligations of security-based swap data repositories;
- Mandatory clearing of security-based swaps;
- Exceptions to the mandatory clearing requirement for hedging by end users;
- Standards for the operation and governance of clearing agencies;
- Registration and regulation of security-based swap execution facilities;
- Definitions of swap and security-based swap dealers, and major swap and security-based swap participants, done jointly with the CFTC;
- Trade acknowledgements for security-based swaps; and
- Conflicts of interest at security-based swap clearing agencies, security-based swap execution facilities, and exchanges that trade security-based swaps.

The Commission also adopted interim final rules regarding the reporting of outstanding security-based swaps entered into prior to the date of enactment of the Dodd-Frank Act. The Division is continuing to develop a number of other proposed rules required by Title VII.

***Ongoing Regulatory Responsibilities.*** Going forward, the Division's regulatory responsibilities will be significantly expanded by the addition of the new categories of registered entities, the required regulatory reporting and public dissemination of security-based swap data, and the mandatory clearing of security-based swaps. In particular, the Division will need to: (1) register the new entities on a rolling basis, coordinating where appropriate with OCIE and other divisions, (2) monitor market developments and promulgate new rules and guidance where needed, and (3) respond to numerous interpretive requests in connection with the requirements applicable to the new registrants. Unlike broker-dealers – for which FINRA performs many front-line supervisory functions – the Dodd-Frank Act does not provide for an SRO performing any of these new regulatory responsibilities.

### **Expanded Responsibilities Related to Credit Ratings**

***Rulemaking/Studies.*** The Division is responsible for 12 separate rules related to NRSROs that are mandated by the Dodd-Frank Act. The SEC must address, among other things, internal controls and procedures, conflicts of interest, credit rating methodologies, transparency, ratings performance, analyst training, credit rating symbology, and disclosures accompanying the publication of credit ratings. In addition, as required by the Act, the Division has reviewed and identified references to ratings in TM administered rules, with a view to eliminating these references. The Division plans to recommend rule proposals to the Commission on these matters in the near future. The Division is also working on three studies required by the Dodd-Frank Act relating to the independence of NRSROs, the standardization of credit ratings, and the process for rating certain structured finance products.

***Exam Coordination.*** The Division is also working with OCIE to assist in the annual examination of each NRSRO, as mandated by the Dodd-Frank Act.

### **Registration and Regulation of Municipal Advisors**

Under the Dodd-Frank Act, the Division also is responsible for implementing a new registration regime for municipal advisors. Last September, the Commission adopted an interim final rule establishing a temporary registration regime for municipal advisors; over 850 have since done so. In December, the Commission proposed a rule to create a permanent registration process, which will require ongoing maintenance and guidance from the Division. The Division has also led the Commission's oversight of changes to the MSRB governance structure that were mandated by the Dodd-Frank Act.

### **Enhanced Clearing Agency Oversight**

Title VIII of the Act provides for enhanced oversight of financial market utilities (FMUs), including clearing agencies registered with the Commission, and payment, clearing or settlement activities that are designated as systemically important. As required by Title VIII, the Division is working closely with the Federal Reserve Board and CFTC to develop a common framework to

supervise FMUs that the Financial Stability Oversight Council (FSOC) designates as systemically important, which will evolve into an ongoing function into FY 2012 and beyond.

### **Accelerated SRO Rule Filing Timeframes**

The Dodd-Frank Act imposed new procedural requirements with respect to the Commission's processing of SRO rule filings, which have substantially increased the Division's workload. For example:

- The Division must expedite its initial review of all filings, because it is now required to send an SRO's proposal to the Federal Register for publication in just over two weeks after receipt – about a third less time than before.
- Where SEC approval is required, the Commission must now take final action on an SRO's proposal within defined timeframes, or the proposed rule will be "deemed to have been approved", regardless of any public comment or whether the Commission has determined that the proposal is consistent with the federal securities laws.

### **Other Dodd-Frank Responsibilities**

TM is responsible for implementing many additional aspects of the Dodd-Frank Act, a number of which will expand the Division's ongoing regulatory functions.

***Rulemakings.*** The Division is currently leading the Commission's implementation of the following mandatory rulemaking provisions:

- Section 619 of the Dodd-Frank Act, commonly referred to as the Volcker Rule, which restricts certain proprietary trading activities of broker-dealers;
- Section 621 of the Act, which places restrictions on certain conflicts of interest arising in connection with certain activities involving asset-backed securities;
- Section 956 of the Act, which required joint rulemaking with other financial regulators concerning certain incentive-based compensation arrangements at broker-dealers and investment advisers; and
- Section 982 of the Act, under which the Commission will update the audit requirements for broker-dealers.

The Division also will be responsible for considering and, as appropriate, recommending proposals to the Commission to implement additional provisions of the Dodd-Frank Act, such as Section 921, which grants the Commission authority to limit or eliminate mandatory pre-dispute arbitration agreements.

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

## **OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS**

Director, Carlo di Florio<sup>7</sup>

A vigorous examination program reduces opportunities for wrongdoing and fraud, and also provides early warning about emerging trends and potential risks in our Nation's capital markets. The Office of Compliance Inspections and Examinations (OCIE) conducts the SEC's National Examination Program. The results of OCIE's examinations are utilized by the Commission to inform rule-making initiatives, to identify and monitor risks, to improve industry practices and to pursue misconduct.

The National Exam Program examines investment advisers, investment companies, broker-dealers, transfer agents, credit rating agencies, exchanges and other SROs such as clearing agencies, FINRA, and the MSRB. In addition to new regulation affecting these registrants, the Dodd-Frank Act introduces new regulation of hedge funds and derivatives and municipal advisers, which will significantly increase our examination responsibilities.

To address these new requirements, OCIE has developed a more risk-based approach to the examination program that will enable us to use our resources more effectively. This approach is necessary, given that the exam program is only able to cover a very small portion of the individuals and entities that register with the Commission, and the disparity between resources and responsibilities is growing as a result of the new requirements of the Dodd-Frank Act. In order to operate a risk-based examination program that effectively identifies and carefully reviews the major risks, we will need more examiners, industry expertise and further technological resources.

### **Recent Reforms**

Over the past year, OCIE has undertaken a broad self-assessment of its strategy, structure, people, processes and technology. This has resulted in a comprehensive improvement plan to break down silos and promote a high-performance culture. Below is an outline of key program improvement initiatives.

*Strategy – Strengthening Our Mission and Risk-Focusing our National Exam Program.* OCIE is implementing many reforms toward an integrated National Exam Program ensuring consistency, effectiveness and efficiency. The cornerstone is a national governance model and enhanced risk-focused exam strategy to better allocate and leverage limited resources to their highest and best use. Four key objectives support our overall mission to protect investors, maintain market integrity and facilitate capital formation:

- **Improve industry compliance** with the securities laws as well as industry risk management and compliance practices through exams and communication with industry.

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<sup>7</sup> Mr. di Florio joined the SEC as the Director of OCIE in January 2010. <http://www.sec.gov/news/press/2010/2010-1.htm>

- **Identify and prevent fraud** through risk-targeted exams and better coordination with the Division of Enforcement in identifying, investigating and preventing fraud.
- **Monitor new and emerging risks** to investor protection and market integrity through joint initiatives with our policy divisions and the Division of Risk, Strategy and Financial Innovation. This includes the development of new risk assessment and surveillance models and risk analytics so we can target the highest risk firms, practices and trends.
- **Inform policy** as the eyes and ears of the SEC in the field, through structured involvement in the rule-making process, and with dedicated policy support teams on key initiatives.

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

- We have a new national governance model that includes regional leadership in key strategic planning, policy setting and performance management decisions.
- We have a new Risk Analysis and Surveillance Unit to enhance our ability to identify the highest risk firms we should be examining and the highest risk issues to focus on in our exams of those firms.
- We have launched new Specialization Working Groups dedicated to enhancing our ability to identify, understand and proactively examine new and complex industry developments, in areas such as structured products, valuation, high-frequency trading and municipal securities.
- We are also looking at how best to staff exams with examiners whose skills sets most effectively address the specific risks in an exam profile. This includes deploying joint IA/BD teams to address issues regarding dual broker-dealer and investment adviser registrants.

While these structural improvements are comprehensive, they are also designed to achieve specific outcomes. For instance, these changes will facilitate better teamwork and collaboration with the policy divisions and also speed alerts, information hand offs, and transitions from OCIE exam staff to the Enforcement Division.

*People – Recruiting Specialists, Improving Training and Strengthening Culture.* In the past year, before the Continuing Resolution necessitated that we suspend recruiting, OCIE was able to recruit people with new skill sets that are critical to supervising our modern capital markets. We have also been building a leading practice training program, introducing mentoring, and building a culture of high-performance, teamwork and accountability. Here are some specific examples:

- We have recruited a limited number of new Senior Specialized Examiners to strengthen our expertise and skills sets in key risk areas, including complex products, risk management, business areas and quantitative analytics.

- We are working to implement a new Certified Examiner Training program that establishes consistent baseline technical training and certification standards across the country.
- We are strengthening management skills and practices through new management and leadership training programs.
- We are launching a mentoring program to support the professional development of our examiners and leverage the expertise and experience of our most seasoned examiners.

*Process – Streamlining Processes to Drive Consistency, Effectiveness and Efficiency.* We have re-engineered our exam process end-to-end. This has enabled us to target more risk-focused examinations, enhance pre-exam preparation, improve multidisciplinary staffing, and increase field supervision. We have become more risk-focused in allocating resources effectively and efficiently. In addition, we have introduced new mechanisms to drive consistency and accountability across our National Exam Program. Here are some examples:

- A National Exam Manual that sets forth updated policies and procedures governing examinations nationwide.
- A standardized National Exam Workbook to drive consistency in the exam process nationwide.
- OCIE’s first Chief Compliance Officer to enhance and monitor compliance with our own policies and procedures, as we expect of our registrants.
- Regular meetings between home office and regional offices to coordinate and monitor performance and compliance.
- Increased use of supervisors in the field and involvement of senior staff on exams.

*Technology – Automating the Exam Process to Keep Pace with New Developments.* We are focusing our technology strategy on moving from a manual to an automated exam process where possible. This includes automating risk assessment and surveillance; exam preparation; all key activities associated with exam execution, such as trade analysis; work paper management and data analytics and reporting. Other technology initiatives include:

- We created a Technology Committee to oversee our technology resources and strategy.
- We have a dedicated Senior Technology Officer who is developing a comprehensive technology strategy, technology architecture and implementation plan to automate and strengthen our exam program.
- We are piloting new risk assessment and trade analysis technologies that will make the program more efficient and effective in identifying risks and wrongdoing throughout the capital markets.

*Governance, Enterprise Risk Management and Internal Controls.* The financial crisis revealed just how dramatically risk management failures can harm investors, jeopardize market integrity and hinder capital formation. It also revealed the need for better oversight of risk at the board

and senior management levels, and the need for stronger independence, standing and authority among a firm's internal risk management, control and compliance functions. As a result, we are focusing in our exams on the overall governance and risk management framework of a firm so we can assess the firm's system of checks and balances.

### **Challenges Facing the Exam Program**

Our new risk-based approach is driven in part by the simple fact that our current examination resources can only cover an even smaller portion of the registrants that we are responsible for examining. Only nine percent of registered advisers were examined in FY 2010 and approximately one-third of advisers registered with the SEC have never been examined. With respect to broker-dealers, the examination program currently only conducts internal control examinations of the 30 largest firms on a three- or four-year cycle. Additionally, out of more than 160,000 broker-dealer branch offices, less than one percent are examined annually.

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

The Dodd-Frank Act shifted the responsibility for examining many smaller advisers to the states. However, the Act expanded the SEC's responsibilities by adding to its jurisdiction municipal advisers, as well as a large number of complex entities, such as five new categories of securities-based swap participants as well as hedge fund and other private fund advisers. The net of all these changes in the registrant population is that, at the beginning of FY 2012, the SEC anticipates that it will oversee nearly 9,000 advisers with close to \$40 trillion of assets under management, 850 groups of registered funds, including third party administrators, more than 5,000 broker-dealers with more than 160,000 branch offices, at least 15 national securities exchanges, and approximately 500 transfer agents. OCIE, together with other Commission divisions and offices, will also oversee, in addition to the 9 active clearing agencies currently examined, a number of additional clearing agencies; the PCAOB; MSRB; FINRA and potentially thousands of municipal advisor entities and individuals. Overall, absent any increase in resources, to a greater extent than is the case today, the expected size of the SEC regulated community in FY 2012 will dwarf the size of the current examination program (currently slightly less than 900 staff nationwide).

Notwithstanding our efforts to make the National Examination Program more effective and efficient, more resources are required for the program to adequately fulfill its mission to protect investors and ensure market integrity. With the addition of approximately 200 FTE positions sought in the 2012 budget, we will be able to conduct more examinations and improve our overall coverage of the industry, as well as better fulfill our new responsibilities under the Dodd-Frank Act. We also should be able to improve our risk analysis approach so that those examinations will be more likely to focus on the areas in greatest need of attention.



## **INVESTMENT MANAGEMENT**

Director, Eileen Rominger<sup>8</sup>

The Division of Investment Management (IM) assists the Commission in executing its responsibility for investor protection and for promoting capital formation through oversight and regulation of America's \$38 trillion investment management industry. A primary function of IM is to administer the Investment Company Act of 1940 and the Investment Advisers Act of 1940 and develop regulatory policy for investment advisers, mutual funds and other investment companies. In order to perform this function, IM works in conjunction with the SEC's Office of Compliance Inspections and Examinations (OCIE), which conducts surveillance and on-site inspections.

### **IM's Core Mission**

#### **Money Market Fund Rulemaking, Oversight, and Surveillance**

Important reforms the Commission adopted in the regulation of money market funds became effective in FY2010 and FY 2011. Included in these amendments was a requirement for money market funds to report their portfolio holdings to the Commission on a monthly basis. The Commission thus has begun more extensive oversight and surveillance of money market funds based on this data. In the coming year, IM plans to continue and expand initiatives to improve its monitoring of money market funds and ability to analyze trends in money market funds' portfolio exposures, liquidity levels and average maturities.

Also, IM is considering recommending additional reforms aimed at further improving the regulatory regime for money market funds and lessening their susceptibility to runs. Last year, the President's Working Group on Financial Markets (of which the SEC Chairman was a member) published a report examining various options for additional money market fund reforms. The Division's staff contributed substantial assistance and resources to this effort and continues to consult with their counterparts in the other agencies that comprise the Financial Stability Oversight Counsel (FSOC). The Commission requested comment on the options discussed in this report and will consider the comments received in evaluating additional regulatory reform.

#### **Other Rulemaking**

In the past year, IM has been engaged in preparing rule proposals and adoptions on a number of important initiatives to protect investors. These include:

- *Rule 12b-1*. The Commission proposed to rescind rule 12b-1, the rule that permits funds to make payments from fund assets for expenses incurred in the distribution of fund share, and replace it with a new rule and regulatory framework governing asset-based distribution fees. IM is currently reviewing the more than 2,000 comments the Commission received on the proposal and will evaluate whether to recommend that the Commission adopt 12b-1 reforms.

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<sup>8</sup> Ms. Rominger joined the SEC as the Director of Investment Management in February 2011.  
<http://www.sec.gov/news/press/2011/2011-14.htm>

- *Target Date Funds.* The Commission proposed changes to rules regarding fund names and marketing materials with respect to target date funds. A target date fund is typically intended for investors whose retirement date is at or around the fund's stated target date. American workers increasingly rely on target date funds for their retirement needs. After consideration of public comments, the Division will evaluate whether to recommend that the Commission adopt rule changes to address target date funds.
- *Investment Adviser Brochures.* In July of last year, the Commission adopted final rules that substantially overhauled the primary disclosure document registered investment advisers must provide their clients and prospective clients. Form ADV, Part 2 – commonly referred to as the “brochure” – includes information on an adviser's qualifications, investment strategies, business practices, and disciplinary information. The new brochures, which will be posted to the Commission's web site as advisers file them, will have expanded content and an improved narrative plain English format.
- *Pay to play.* The Commission adopted in June of last year a new rule to address so-called “pay to play” practices in which investment advisers make campaign contributions to elected officials in order to influence the award of contracts to manage public pension plan assets and other government investment accounts. The rule, adopted in response to a growing number of reports of such activities across the country, is intended to combat pay to play arrangements at the state and local government level in which advisers are chosen based on their campaign contributions to political officials rather than on merit.

### **Interpretive Advice and Exemptive Relief**

In addition to its role in Commission rulemaking, IM provides formal and informal legal guidance in the form of interpretive and no-action letters, exemptive relief, interpretive releases, memoranda, and other letters and materials. In FY 2010, the staff closed 921 matters involving formal and informal legal guidance.

### **Review of Filings**

IM reviews filings of investments companies that register under the Investment Company Act of 1940 and register their securities under the Securities Act of 1933 to both monitor and enhance compliance with disclosure and accounting requirements. The filings reviewed include initial registration statements, post-effective amendments thereto, and proxy statements. Under Commission rules, some filings containing non-material changes or disclosure that is substantially similar to a prior filing may not be subject to staff review or subject to a limited review. Pursuant to requirements under the Sarbanes-Oxley Act of 2002, the Division reviews the annual reports of all investment companies no less frequently than once every three years.

### **International Coordination**

Funds and the advisers that operate them, including private funds and private fund advisers, frequently operate on a global basis. The active participation of IM staff with technical expertise in international working groups is essential to the fulfillment of the Commission's international responsibilities. For example, IM staff recently participated in work of the International Organization of Securities Commissions designed to help regulators assess the systemic risk

posed by hedge funds and other private funds on a global basis by collecting consistent and comparable information. Such participation also helps promote international standards that are consistent with Commission policy.

### **Enforcement Liaison**

The Division regularly provides formal and informal legal and policy guidance to the Division of Enforcement on enforcement matters. In 2010, IM reviewed over 500 enforcement-related matters from the Division of Enforcement, and expects to review approximately the same number of enforcement-related matters in 2011. In addition, IM conducts reviews of disciplinary disclosures in new or amended Forms ADV filed by registered investment advisers. The Division also responds to IM-related tips, complaints and referrals and has assisted in the Commission's development of a Commission-wide TCR system.

### **Implementing Provisions of the Dodd-Frank Act**

Currently, IM is focusing its rulemaking program on implementing the provisions of the Dodd-Frank Act as they relate to investment companies and advisers, and, as rules are adopted, much of the work will shift to the Division's disclosure, interpretive advice and exemptive relief programs. These include:

***Investment Adviser Regulation.*** The Dodd-Frank Act changed the universe of regulated entities for which the Commission is responsible by increasing the statutory threshold for SEC registration by investment advisers to \$100 million in assets under management; requiring advisers to hedge funds and other private funds to register with the Commission (the staff anticipates this will add approximately 750 new private fund advisers to the registrant pool); and requiring reporting by certain investment advisers that are exempt from registration. While the number of registered advisers is anticipated to shrink overall by 28 percent, the total assets managed by advisers registered with the Commission are expected to rise.

In November, the Commission proposed new rules and rule amendments, including amendments to Form ADV, to implement the provisions of the Act described above. Concurrently, the Commission proposed rules to implement new exemptions from registration created by the Dodd-Frank Act for advisers to certain private funds and for certain foreign private advisers. The new rules would define "venture capital fund," provide for an exemption for advisers with less than \$150 million in private fund assets under management in the United States, and clarify the meaning of certain terms included in the foreign private adviser exemption. The comment period for both proposals ended on January 24, 2011. After review of the comments received by the Commission on these proposals, the staff plans to recommend in FY 2011 that the Commission adopt rules and rule amendments implementing these Dodd-Frank Act provisions.

Earlier in FY 2011, the Commission proposed an exclusion from the definition of investment adviser for certain family office investment advisers as directed by the Dodd-Frank Act. The staff also is reviewing the comments received and preparing a rule adoption for Commission consideration on this matter.

***Systemic Risk Reporting.*** In January, the Commission proposed reporting requirements for private fund investment advisers to assist FSOC in monitoring for potential systemic risk, in

accordance with the Dodd-Frank Act. Following consideration of the comments received, the staff in FY 2011 expects to prepare a rule adoption for Commission consideration. For purposes of monitoring this information and the new information received from money market funds, the Division hopes to hire additional staff with the expertise necessary to analyze, answer inquiries, and develop reports with respect to this systemic risk information.

### **CROSS-DIVISIONAL STUDIES**

In addition, we have undertaken a number of cross-divisional studies required by the Dodd-Frank Act, including:

***Investment Adviser/Broker Dealer Fiduciary Study.*** In January 2011, SEC staff completed a study required by Section 913 of the Dodd-Frank Act that, among other things, evaluated the effectiveness of existing legal or regulatory standards of care for broker dealers and investment advisers when providing personalized investment advice about securities to retail customers.<sup>9</sup> The study also evaluated whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the applicable standards of care for brokers, dealers, and investment advisers that should be addressed. SEC staff recommended that the Commission adopt rules, consistent with Congress' grant of authority in the Dodd-Frank Act, which would apply a uniform fiduciary standard of conduct to both broker-dealers and investment advisers when providing personalized investment advice about securities to retail investors. As provided for in the Dodd-Frank Act, this fiduciary standard would be no less stringent than the standard that currently applies to investment advisers under the Investment Advisers Act. SEC staff also recommended that the Commission consider whether certain regulations applicable to broker-dealers and investment advisers should be harmonized to add meaningful investor protection. The staff expects to recommend to the Commission proposed rules as may be appropriate based on the study's recommendations.

***Study on Enhancing Investment Adviser Examinations.*** In January 2011, IM staff, with assistance from other divisions and offices, completed a study required by Section 914 of the Dodd-Frank Act that reviewed the need for enhanced examination and enforcement resources for investment advisers that are registered with the Commission.<sup>10</sup> The study describes the decrease in the number and frequency of examinations of registered investment advisers over the past several years and explores how the number and frequency of examinations are likely to change as a result of, among other things, the Dodd-Frank Act's amendments to the Advisers Act's registration provisions. The study notes that the Commission likely will not have sufficient capacity in the near or long term to conduct examinations of registered investment advisers with adequate frequency, and that the Commission's examination program requires a source of funding that is adequate to permit the Commission to meet the new challenges it faces and

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<sup>9</sup> Commissioners Casey and Paredes did not support release of the study as published and issued a separate statement in conjunction with publication of this study. The study is available at <http://www.sec.gov/news/studies/2011/913studyfinal.pdf>; The statement by Commissioners Casey and Paredes is available at <http://www.sec.gov/news/speech/2011/spch012211klctap.htm>.

<sup>10</sup> Commissioner Walter issued a separate statement in conjunction with publication of this study. The study is available at <http://www.sec.gov/news/studies/2011/914studyfinal.pdf>; The statement by Commissioner Walter is available at <http://www.sec.gov/news/speech/2011/spch011911ebw.pdf>.

sufficiently stable to prevent adviser examination resources from periodically being outstripped by growth in the number of registered investment advisers. The study highlights three options to strengthen the Commission's investment adviser examination program: (1) imposing user fees on SEC-registered investment advisers to fund their examinations; (2) authorizing one or more self-regulatory organizations that assess fees on their members to examine, subject to SEC oversight, all SEC-registered investment advisers; or (3) authorizing FINRA to examine a subset of advisers – i.e., dually registered investment advisers and broker-dealers – for compliance with the Advisers Act.

***Financial Literacy Study.*** The Dodd-Frank Act requires the SEC to conduct a study and draft a report, due in FY 2012, which assesses the existing financial literacy of retail investors, and identifies methods to improve disclosures made to investors and the most useful information investors need to make informed investment decisions. The Act specifically identifies mutual fund investments and point of sale disclosures to be covered by particular aspects of the study. This study is being led by the Commission's Office of Investor Education and Advocacy.

## **Conclusion**

While the SEC has made substantial progress in reforming its operations and increasing its efficiency, our efforts are ongoing. Our budget request reflects this need to further improve our internal operations, and also provides the resources needed to accomplish our core mission, implement the responsibilities given to us under the Dodd-Frank Act, and undertake badly needed new technology initiatives. Investors and our markets deserve nothing less. We look forward to continuing to work closely with Congress as this legislative session continues, and we are happy to answer any questions you may have.