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"

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by
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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.

<u>Penalty Pilot Program & Formal Orders</u>

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.

[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

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[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

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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

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[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.