OVERSIGHT OF THE U.S. SECURITIES AND EXCHANGE COMMISSION: EVALUATING PRESENT REFORMS AND FUTURE CHALLENGES

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

JULY 20, 2010

Printed for the use of the Committee on Financial Services

Serial No. 111–144

U.S. GOVERNMENT PRINTING OFFICE

61–848 PDF WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

BARNEY FRANK, Massachusetts, *Chairman*

PAUL E. KANJORSKI, Pennsylvania
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
DENNIS MOORE, Kansas
MICHAEL E. CAPUANO, Massachusetts
RUBÉN HINOJOSA, Texas
WM. LACY CLAY, Missouri
CAROLYN MCCARTHY, New York
JOE BACA, California
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
MELISSA L. BEAN, Illinois
GWEN MOORE, Wisconsin
PAUL W. HODES, New Hampshire
KEITH ELLISON, Minnesota
RON KLEIN, Florida
CHARLES A. WILSON, Ohio
ED PERLMUTTER, Colorado
JOE DONNELLY, Indiana
BILL FOSTER, Illinois
ANDRÉ CARSON, Indiana
JACKIE SPEIER, California
TRAVIS CHILDERS, Mississippi
WALT MINNICK, Idaho
JOHN ADLER, New Jersey
MARY JO KILROY, Ohio
STEVE DRIEHAUS, Ohio
SUZANNE KOSMAS, Florida
ALAN GRAYSON, Florida
JIM HIMES, Connecticut
GARY PETERS, Michigan
DAN MAFFEI, New York

SPENCER BACHUS, Alabama
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
RON PAUL, Texas
DONALD A. MANZULLO, Illinois
WALTER B. JONES, JR., North Carolina
JUDY BIGGERT, Illinois
GARY G. MILLER, California
SHELLEY MOORE CAPITO, West Virginia
JEB HENSARLING, Texas
SCOTT GARRETT, New Jersey
J. GRESHAM BARRETT, South Carolina
JIM GERLACH, Pennsylvania
RANDY NEUGEBAUER, Texas
TOM PRICE, Georgia
PATRICK T. MCHENRY, North Carolina
JOHN CAMPBELL, California
ADAM PUTNAM, Florida
MICHELE BACHMANN, Minnesota
KENNY MARCHANT, Texas
THADDEUS G. McCOTTER, Michigan
KEVIN McCARTHY, California
BILL POSEY, Florida
LYNN JENKINS, Kansas
CHRISTOPHER LEE, New York
ERIK PAULSEN, Minnesota
LEONARD LANCE, New Jersey

JEANNE M. ROSLANOWICK, *Staff Director and Chief Counsel*

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

PAUL E. KANJORSKI, Pennsylvania, *Chairman*

GARY L. ACKERMAN, New York
BRAD SHERMAN, California
MICHAEL E. CAPUANO, Massachusetts
RUBÉN HINOJOSA, Texas
CAROLYN McCARTHY, New York
JOE BACA, California
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
NYDIA M. VELÁZQUEZ, New York
CAROLYN B. MALONEY, New York
MELISSA L. BEAN, Illinois
GWEN MOORE, Wisconsin
PAUL W. HODES, New Hampshire
RON KLEIN, Florida
ED PERLMUTTER, Colorado
JOE DONNELLY, Indiana
ANDRÉ CARSON, Indiana
JACKIE SPEIER, California
TRAVIS CHILDERS, Mississippi
CHARLES A. WILSON, Ohio
BILL FOSTER, Illinois
WALT MINNICK, Idaho
JOHN ADLER, New Jersey
MARY JO KILROY, Ohio
SUZANNE KOSMAS, Florida
ALAN GRAYSON, Florida
JIM HIMES, Connecticut
GARY PETERS, Michigan

SCOTT GARRETT, New Jersey
TOM PRICE, Georgia
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
FRANK D. LUCAS, Oklahoma
DONALD A. MANZULLO, Illinois
EDWARD R. ROYCE, California
JUDY BIGGERT, Illinois
SHELLEY MOORE CAPITO, West Virginia
JEB HENSARLING, Texas
ADAM PUTNAM, Florida
J. GRESHAM BARRETT, South Carolina
JIM GERLACH, Pennsylvania
JOHN CAMPBELL, California
MICHELE BACHMANN, Minnesota
THADDEUS G. McCOTTER, Michigan
RANDY NEUGEBAUER, Texas
KEVIN McCARTHY, California
BILL POSEY, Florida
LYNN JENKINS, Kansas

CONTENTS

	Page
Hearing held on:	
July 20, 2010	1
Appendix:	
July 20, 2010	41

WITNESSES

TUESDAY, JULY 20, 2010

Schapiro, Hon. Mary L., Chairman, U.S. Securities and Exchange Commission	11

APPENDIX

Prepared statements:	
Kanjorski, Hon. Paul E.	42
Klein, Hon. Ron	44
Schapiro, Hon. Mary L.	46

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Schapiro, Hon. Mary L.:	
Written responses to questions submitted by Hon. Spencer Bachus	66
Written responses to questions submitted by Hon. Carolyn McCarthy	72
Written responses to questions submitted by Hon. Ed Royce	73

OVERSIGHT OF THE U.S. SECURITIES AND EXCHANGE COMMISSION: EVALUATING PRESENT REFORMS AND FUTURE CHALLENGES

Tuesday, July 20, 2010

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

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

Members present: Representatives Kanjorski, Ackerman, Sherman, McCarthy of New York, Baca, Lynch, Scott, Maloney, Bean, Klein, Perlmutter, Donnelly, Carson, Minnick, Adler, Himes; Garrett, Manzullo, Royce, Biggert, Hensarling, Neugebauer, McCarthy of California, Posey, and Jenkins.

Ex officio present: Representative Bachus.

Chairman KANJORSKI. This hearing of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises will come to order. Pursuant to committee rules, each side will have 15 minutes for opening statements. Without objection, all members' opening statements will be made a part of the record.

Good morning. We meet today to consider the current performance and future plans of the United States Securities and Exchange Commission. When taking over the agency nearly 18 months ago, Chairman Schapiro faced considerable challenges, perhaps none greater than restoring the Commission's reputation in the wake of the collapse of sizable investment banks and the revelation of the $65 billion Madoff fraud. This massive Ponzi scheme made it undeniably clear that the Commission's examination, oversight and enforcement programs had serious weaknesses and required substantial reforms.

During her tenure and using the powers she already had, Chairman Schapiro has pursued an ambitious results-oriented agenda aimed at protecting investors and restoring confidence. She has shaken up the Commission's senior management.

While she has already accomplished much, Chairman Schapiro also faces many more hurdles in the coming months, especially as she works to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act, which will become law tomorrow. This statute grants the Commission many new powers and endows it with significant new responsibilities. Today, Congress will carry out its constitutional oversight mandate by closely examining what the Commission has already done for better protection of investors, to facilitate capital formation, and to maintain fair, orderly, and efficient markets. We will also begin comprehensive oversight of the Administration's implementation of the new Wall Street reform law.

I believe that Congress must focus like a laser beam on this issue by holding regulators accountable for their performance under this landmark statute. As a result, this hearing is the first of many that I intend to hold on issues related to the new law.

Under the Wall Street reform law, the Commission will, independently and in cooperation with other agencies, write and police more than 100 new rules on issues like the sale of derivatives, the fiduciary duty of broker-dealers, the nomination of board directors by investors, and mandatory arbitration clauses inserted into securities contracts.

Additionally, the law will require the Commission to complete a score of studies under very tight deadlines.

This historic agreement also subjects credit rating agencies to greater accountability through new liability standards, and the Commission will issue rules that, among other things, establish a system to prohibit issuers of structured finance products from picking the entity that provides the initial credit rating.

The statute further empowers the Commission to register and oversee hedge fund managers and other private fund advisers. Moreover, this landmark law aims to modify the structure of the agency to make it more nimble and responsive to the ever novel innovations of Wall Street.

In addition to the offices and other structural reforms that it will uphold, the bill contains my proposal to require an independent, external, comprehensive examination and overhaul of the Commission. This overhaul effort will ensure that a fresh look at the inner workings of the agency is taken in order to help rectify any remaining problems and make sure that the Commission and its partners can effectively and efficiently detect and stop Wall Street fraudsters.

As we proceed today, we will undoubtedly review the recent developments that have garnered eye-catching headlines on the front pages of America's newspapers. For example, we need an update about the structural reforms put in place after the markets' temporary plunge on May 6th. We also need to shed more light on last week's eye-popping $550 million settlement from Goldman Sachs.

I, for one, am hopeful that this legal action will be the first and not the last brought by the Commission against the hucksters of Wall Street who spun toxic mortgages into golden financial opportunities by hiding information or defrauding investors by other means.

In closing, I look forward to hearing from Chairman Schapiro on the reforms implemented by the Commission during the last year; its pending initiatives; and most importantly, on how the Commission expects to implement the many new powers and authorities contained in the conference agreement to reform the ways of Wall

Street operation. Because too many Americans have lost their retirement nest eggs, we cannot rest. We must continue to work to improve the effectiveness of this support in the agency.

The Chair now recognizes the gentleman from New Jersey, Mr. Garrett, for 4 minutes.

Mr. GARRETT. I thank the chairman.

I think there is a lot on the SEC's plate these days, and I am pleased that we are having this hearing to do our proper oversight and explore really the myriad of issues that are important to the future of the markets.

Obviously, one of the top things on the SEC's to-do list, since this bill will be signed into law soon, is to begin a very aggressive and far-reaching set of rulemakings that is called for in this 2,300-page financial regulatory bill. And of the around 243 new rulemakings under the Dodd-Frank bill, there is one estimate of 95 or more under the purview of the SEC. So certainly concerns that the timetable for finalizing these rules that the bill mandates is really not appropriate. It will cause the SEC to move perhaps too quickly on items that should be considered in a thoughtful and reasonable, responsible manner.

Never mind the question of whether some of these rules should be considered at all. Of course, these concerns are magnified because much of the rulemaking, especially in the area of derivatives, must be done in a joint manner with the CFTC, making that process even more complicated and ripe for politically-based, rather than policy-based, solutions. So the regulatory reform rulemaking is all in all in addition to the number of major items that the SEC was already working on prior to this, and one of these areas is the concept release on market structure in which the Commission is examining a broad array of issues related to the proper functioning of the markets.

Now, among the issues the SEC is looking at is the concept release, the role of high-frequency trading in today's market. And recently, Chairman Schapiro has been quoted on a number of occasions about our apparent concerns over the speed in which orders are now electronically processed. Apparently, the Commission is or will be reviewing whether some of these trades proceed too fast.

I have some concerns with the Commission's focus in this area. While it can be difficult for the human mind to fathom the speed with which these transactions are processed, putting some sort of artificial governors on the trade seems to me to be a strategy that will likely produce a host of unintended consequences, one of which is liquidity could be significantly curtailed. Another could be increased, rather than decreased, volatility. So those are issues to be addressed.

In a related note, I again want to highlight a portion of my April 22nd letter on the market structure release. In the letter, I express concern that the Commission's request for comments respecting the interests of long-term and short-term investors seems to focus on a perceived conflict between such groups with little to no reference to the critical interdependency between these groups and the overall equities market structure. And I am hopeful that the tone of such requests is not reflective of the SEC's analytical framework, and I would urge the Commission to consider that should be determined that additional rulemaking be required. The most successful outcome would be one that benefits their synergistic relationship as a whole.

In another item, in addition to that, that I have touched on in the past and plan on exploring more going forward, is to what extent union or civil servant protections are hampering the Chairman's ability to properly discipline or fire SEC employees who are either engaged in improper misconduct in the workplace or simply not competent or simply lazy in their pursuit of protecting investors from the likes of Bernie Madoff.

As Governor Christie, in my home State of New Jersey, has demonstrated so very well I think, everything needs to be on the table as we reexamine issues that may be contributing to overly costly or inefficient or ineffective government. The taxpayers in my State, or the entire country, deserve nothing less, and we cannot afford to do anything less.

Also, on this point of the Madoff issue, the Securities Investor Protection Corporation, or the SIPC, is supervised by the SEC. So I will be interested to hear from Chairman Schapiro on what her thoughts are on whether it is just or appropriate for the SPIC-appointed trustees to be pursuing so-called clawback provisions from investors who have already lost millions because of Madoff's fraudulent behavior and the SEC's incompetence or inability to prosecute that behavior.

If the IRS, a Federal Government entity, relied on investor statements to calculate taxes owed, shouldn't the investors be able to rely on the IRS—or on the statements as well?

So, in conclusion, I don't envy Chairman Schapiro with the number of issues that are on your plate. The ones I have touched on here only are beginning to scratch the surface. And I appreciate Chairman Kanjorski's comment with the regard to the idea for future hearings and the like as far as oversight. And that is why it is so important that we have this hearing today.

So, I appreciate Chairman Schapiro coming today to testify.

Chairman KANJORSKI. Thank you very much, Ranking Member Garrett.

Now, we will hear from the gentleman from New York, Mr. Ackerman, for 3 minutes.

Mr. ACKERMAN. Thank you, Mr. Chairman.

During the course of today's hearing, we will no doubt discuss the role of the SEC in the wake of the passage of the Dodd-Frank bill, the most significant financial reform legislation since the Great Depression.

As Chairman Schapiro noted in her written testimony this morning, once President Obama signs the bill into law tomorrow, the SEC will become responsible for promulgating an enormous number of new rules, creating five new offices, and undertaking several studies, most of which must be completed within the next year or two.

But this morning, I would like to discuss national security. Three weeks ago, President Obama signed the Comprehensive Iran Sanctions, Accountability, and Divestment Act into law. This historic legislation expands the types of transactions American firms are prohibited from entering into with Iran so as to preclude selling

Iran refined petroleum, supporting Iran's domestic refining efforts or selling Iran goods or services that assist in developing its nuclear sector.

The bill bans U.S. banks from engaging in financial transactions with foreign banks doing business with the Iranian military, from helping to facilitate Iran's illicit nuclear programs, or from aiding Iran's support for terrorism.

The Act also holds U.S. banks accountable for actions by their foreign subsidiaries. Accordingly, foreign firms whose equity may be partially or fully held by U.S. funds or investors are also subject to the new sanctions, including not only those involved in Iran's energy sector but also those foreign financial institutions doing business with key Iranian banks or the Iranian military, as well as companies that sell goods or services that facilitate human rights abuses by the Iranian regime.

The sanctions are crippling. And the penalties for firms determined to be in violation of these sanctions are equally punitive. And they should be.

A nuclear Iran poses existential threats to the United States and its allies and companies must be held accountable for assisting Iran in its determination to develop nuclear capabilities and shun the international community.

So what does Iran have to do with our capital markets? The potential for American investors to suffer material losses if their investments are in firms determined to be in violation of new sanctions is very real. As Chairman Schapiro knows, the SEC has a very important role to play under the Comprehensive Iran Sanctions, Accountability, and Divestment Act. American investors need to know if the companies and funds in which they invest face potential and substantial Iran-related sanctions.

As the watchdog for our markets and exchanges, the SEC will be tasked with ensuring that investors have ready access to information pertaining to any potential sanctions the U.S. exchange-listed firms and funds in which they have invested will be subject to.

Madam Chairman, this morning I presented you with a letter asking for your attention to these issues and assuring that U.S. investors are forewarned about potential exposure to significant losses. I would appreciate if you could address the Commission's role under the Comprehensive Iran Sanctions, Accountability, and Divestment Act this morning, and how the Commission plans to empower investors placing their money with firms involved in illegal transactions with Iran.

I thank you for your continued hard work to provide confidence in the stability of our capital markets, and I yield back the balance of my time.

Chairman KANJORSKI. Thank you, Mr. Ackerman.

We will now hear from the ranking member of the full committee, the gentleman from Alabama, Mr. Bachus, for 4 minutes.

Mr. BACHUS. Thank you. Thank you, Mr. Chairman. I thank you for holding the hearing which I think Mr. Garrett and I requested.

This is actually the second oversight hearing; the first one was last July, Chairman Schapiro.

And we appreciate you being here today.

Chairman Schapiro, I understand you inherited a Commission with a tarnished reputation and significant personnel problems. I think you have performed admirably, attempting to revitalize the Commission's culture.

But clearly, as you have said, more fundamental improvements are necessary. If there are legal impediments preventing you from further transforming the agency, particularly with the civil service laws, it is our hope that we can use these oversight hearings to learn what measures can be taken to manage the Commission more effectively and demand high ethical and professional standards from its employees.

In the past 2 years, we have experienced the collapse of Bear Stearns, Lehman Brothers, and ultimately the Consolidated Supervised Entity Program, the breaking of the buck by the reverse primary fund, the multibillion dollar Madoff and Stanford Ponzi schemes, as well as numerous operational and personnel problems identified by the SEC's Inspector General. These very significant and recent failures give us all the more reason to conduct aggressive oversight and to demand, along with you, that the SEC be more accountable at all levels of the agency.

What many of us find particularly troubling, and I know you do, too, is that the majority of the SEC's problems were caused by its failure to use its existing authority to protect investors to address fraud and other sharp practices in already heavily regulated areas of our capital market.

I want to conclude my statement today by saying this: As we have seen with subprime lending, when everyone is in charge of a problem, no one is in charge. Shared responsibility resulted in inaction because the agencies were never able to agree on what action to take or even recommend. We also saw that with credit cards.

Now, we have the Dodd-Frank Act that the President will sign into law tomorrow, and it gives numerous regulators, in my opinion, vague new authorities to regulate various entities. So you have all these rules and regulations that you are having trouble enforcing, and now you have a whole other set of regulations and rules.

For instance, as a result of this new legislation, clearinghouses and so-called financial market utilities will be required to process vast dollar amounts of derivative products. And today, that is just between different entities. It doesn't go in a clearinghouse.

Will they become the next "too-big-to-fail" entities? Is there an implied government guarantee or even an explicit one that they will not be allowed to fail? The SEC—or the CFTC is the primary regulator of many of these clearinghouses and financial market utilities today. Will that continue to be the case? The Federal Reserve, in many cases, appears to be the ultimate regulator of many institutions where you are the prime regulator today. Will they be the regulator in charge if the regulators cannot agree? And what is the role of the Financial Stability Oversight Council as it relates to clearinghouses and financial market utilities? Will they have an independent regulatory role?

These questions and others may not be answered for years, and therefore, the uncertainty that existed before this legislation passed, if anything, will only increase.

Finally, this legislation increases the threat that the SEC will create more uncertainty in our capital markets through the exercise of new powers to reform practices that in no way contributed to the financial crisis. The crisis was not caused by arbitration agreements, corporate governance rules, or the broker-dealer suitability standards. Nonetheless, the Act requires the SEC to address these perceived problems.

Obviously, you are faced with a lot of questions, and one of them is, are you ultimately in charge or do you have to work with the other agencies, and who makes the final decisions? And that is going to be something that is going to require additional oversight and coordination, not only between the Congress and your agency but between the agencies. Thank you.

Chairman KANJORSKI. Thank you, Mr. Bachus.

Now, we will hear from the gentleman from California, but before he starts, may I remind the members of the committee that we have assigned time, and I hope that we would hold to that time. A few of us have gone over that time this morning.

Let us hold to the 3 minutes that are allocated.

The gentleman from California, Mr. Sherman.

Mr. SHERMAN. Thank you.

I would like to associate myself with the statements of Mr. Ackerman. It is critical that the SEC make sure that investors are aware of those corporate actions that would cause the issuer to be subject to sanctions under the newly passed bill.

Many people have mentioned the Madoff case. I should point out, that should have been detected in the first 15 minutes of review, because the first thing that should happen when the SEC gets a financial statement is, you look at the auditor's report. And that would raise the issue, is the auditor large enough to do the audit? Had that question been asked, Madoff would have been detected in 15 minutes or so. And I would hope that some basic reviews go on with financial statements filed with the SEC by broker-dealers, investment advisers, etc. And that should include the most basic question, and that is, who is the auditor, and is that auditor qualified to do the audit?

I want to focus on credit rating agencies. The chairman has excellent language in the bill that will be signed tomorrow that, as I understand it, becomes effective immediately, but there are two other aspects dealing with credit rating agencies that really don't have effect until the SEC takes action. The first of these is designed to make sure that credit rating agencies are fair to municipal issuers. Right now, we have a circumstance where bonds of corporate issuers get one set of grades, municipal issuers another, and I think investors are misled into thinking that the corporates are better. The fact is when a municipal issuer defaults, its revenue stream continues, and therefore, usually the bondholders are paid in full; whereas, if you held bonds in Circuit City, you are aware that when a corporation defaults, its revenue stream is ended by the going-out-of-business sale. Municipalities and States do not have going-out-of-business sales. They stay in operation and continue to collect revenue.

Most importantly, are the provisions designed to make sure that the issuer, particularly of structured investments, does not select the credit rating agency? In October, I submitted in this room an amendment to require the SEC to establish a panel to select the credit rating agency. I ended up settling for a hearing which now I don't think is necessary because Senator Franken was able to get the core of my language and some expanded language into the bill.

I want to make sure that the SEC is dedicated to the objective of that amendment, which is whether you go with the exact Franken language or not, that the issuer will not select the credit rating agency.

I yield back.

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

Now, we will hear from the gentleman from California, Mr. Royce, for 2½ minutes.

Mr. ROYCE. Thank you, Mr. Chairman.

There is a clear difference, I think, between the American approach and the British approach in dealing with a calamity in financial regulation. In the United States, we have a history of tinkering around the edges. We add additional agencies when a crisis comes.

In Britain, they are more open-minded about fundamentally reorganizing an entity when it has failed. People lose their heads there. They will even disband the agency altogether and start fresh.

We have heard time and time again about the overlawyering, the bureaucratic delays, the investigative ineptitude. We heard that from our copulas here at the SEC. The fact that it took the agency 16 years to uncover the Madoff Ponzi scheme and the fact that had the financial tide not gone out, it probably would have been until his death that was carried on, I think shocks the members of this committee. And the fact that the SEC had known about the Stanford Ponzi scheme since 1997. According to the SEC's Inspector General, one SEC supervisor used her work e-mail account on virtually a daily basis to conduct business on behalf of the operator of a Ponzi scheme in Arizona. These problems did not arise from simply a lack of funding but rather a deeper, structural flaw within the SEC.

So how does Congress treat an agency that has performed so poorly over the years? We reward it. The bill awaiting the President's signature vastly expands the regulatory authority without reforming the troubled agency, and under the bill, the agency will promulgate 123 rules, conduct 32 studies, and establish 7 new offices within the SEC.

This is in stark contrast, as I said, to the approach taken by the Brits. As the headline in the Financial Times recently noted, "FSA to be Abolished in Osborne Shake-up."

So, Ms. Schapiro, you have committed to at least begin the reformation of the SEC, and I commend you for that. We spoke last week about that. But time will tell whether real reform can come from within the agency or whether we would be better served taking a page out of England's playbook and fundamentally restructuring this agency.

I look forward to your testimony. Thank you.

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

Now, we will hear from the gentleman from Massachusetts, Mr. Lynch, for 1½ minutes.

Mr. LYNCH. Thank you, Mr. Chairman.

I want to thank Chairman Schapiro for attending the hearing and helping us with our work, especially in light of the recently passed reform bill, as well as the recent settlement with Goldman Sachs totaling over $550 million.

Madam Chairman, last summer, we had an SEC oversight hearing in Boston where I expressed the concern about the resources that are available to the SEC to perform its duties and fulfill its responsibilities. A look back at the SEC budget reveals that while the financial markets were exploding in size and in complexity, the SEC budget remained fairly flat and, in some cases, actually shrank. I am pleased that the SEC receives enhanced resources under the new bill, but it also gets a lot of new responsibilities as well. So you have a tough row to hoe. But I would like to work with you.

I had an opportunity to meet with some of the new heads of the department that you have appointed in this new structure, the Enforcement Division and the Division of Risk, Strategy, and Financial Innovation. I am encouraged by the new leadership. I am optimistic. But I also know you have a tremendous task in front of you.

So I would like to hear in the hearing in your testimony about how we are going to tackle that and get down to the real mechanics. But thank you for attending, and I yield back the balance of my time.

Chairman KANJORSKI. Thank you, Mr. Lynch.

I will now hear from the gentleman from Texas for 2½ minutes, Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

After our last hearing with the SEC Chairman, I think it was made clear that, at least under the previous management, the SEC did have the authority under the Consolidated Supervised Entities Program to do something about the dangerous levels of leverage at Lehman Brothers. Unfortunately, they chose not to exercise that authority.

The situation was not dissimilar to that of AIG. We know we had the former Director of the Office of Thrift Supervision, who testified before the committee that OTS did have the authority to properly regulate AIG, but again, they chose not to do it.

In case after case, regulators had the authority to prevent behavior that contributed significantly to our economic debacle. Whether it was a matter of ignorance, negligence, incompetence or frankly simply making a mistake, a very costly mistake, we don't know.

And so many of us find it somewhat ironic that now the financial regulatory bill that is awaiting the signature of the President in many respects rewards regulators who missed and contributed to the financial crisis with yet even more regulatory authority and does little or nothing about ignorance, negligence, incompetence, and simple mistakes.

Clearly, the SEC will be getting significant new authority in addition to their tremendous workload. I have heard some estimates of 95 new rulemakings, some say 123; 32 studies, 19 additional actions and reviews. Obviously, all of this new authority and responsibility is against the backdrop of the Lehman Brothers failure, the Madoff Ponzi scheme and the SEC pornography scandal that revealed senior SEC officers clearly had more time to view pornography than they did to police security fraud.

I hope that the SEC is capable of improving its track record while also taking on these new responsibilities.

Clearly, as we look around in our economy, one of the greatest challenges we have to job creation is frankly not a lack of capital; it is a lack of confidence. And I am curious, with all this new regulatory authority that will be granted to the SEC, how will the SEC handle the levels of uncertainty that have been created by this new law?

Already, the Federal Reserve reports that public companies are sitting on almost $2 trillion of cash and liquid securities. We need to get that money out of the stands, onto the playing field, and the actions of the SEC will bear greatly upon that.

Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you, Mr. Hensarling.

Now, we will hear from the gentleman from Georgia, Mr. Scott, for 1½ minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman.

Welcome, Chairman Schapiro. You have quite a challenge before you with our newly, about-to-be-signed, Wall Street reform bill.

As you go about your testimony, I would be very interested for you to sort of explain to us your interpretation of what you see your role is under this new bill, particularly in relationship to protecting our investors, stabilizing our financial markets, how you are going to regulate over-the-counter derivatives, and how you are going to rein in excessive risk-taking.

And, of course, we want to know your concerns about the new role and the concerns that you raise in terms of the implementation of your impending expansion of your duties. But I am particularly concerned that you express to us today how you see your role playing out in the implementation of the Iran Sanctions Act. You have a very critical role in that, especially given the fact that the real meat and potatoes of this sanctions bill is within the financial community, as well as investments in their infrastructure of the importation and of refined gasoline.

I look forward to your testimony. Thank you for being here.

Chairman KANJORSKI. Thank you, Mr. Scott.

Now, we will hear from the gentleman from California, Mr. McCarthy, for 2 minutes.

Mr. MCCARTHY OF CALIFORNIA. Thank you, Mr. Chairman. I thank you for scheduling this hearing.

I look forward to hearing from the SEC Chairman about her agenda, especially given the movement of the bill, the new responsibilities and funding for the Commission.

As you know, Chairwoman Schapiro, I remain very interested in how the SEC coordinates its inspections and examination staff and the activities with the policymaking division of the trading and markets and investment management. As you have made internal changes, I am interested in an update on how you have integrated processes to avoid the stove-piping.

In a similar vein, your post-Madoff reforms indicate a new protocol in the New York regional office to better integrate broker-dealer and investment advisor examinations with a goal of having the most knowledgeable staff coordinating the exams. I hope you will be able to address how this kind of cross-training is working, and if so, how could it work across the Nation so that we can better be able to examine and find the Madoff scandals sooner and not be able to move forward?

I yield back the balance of my time.

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

Now, we will hear from the gentleman from Indiana for 1 minute, Mr. Carson.

Mr. CARSON. Thank you, Mr. Chairman, for holding this important hearing today.

While we are continuing to see signs of an economic recovery, it is critical that we take steps to prevent another financial crisis of this depth and duration.

One of the most important things that the SEC can do to help the economy towards sustainable growth is to be the most effective market regulator, protecting investors while also encouraging capital formation and investment. Undoubtedly, the SEC has undertaken many reforms to protect the interests of investors. And I hope that it will live up to its mandate of protection.

As the economy recovers, it is imperative that we continue to focus additional firepower on behalf of investors who might otherwise lose their confidence in the integrity of these markets.

Thank you, and I yield back.

Chairman KANJORSKI. Thank you, Mr. Carson.

Now, it is my pleasure to introduce and welcome one of our witnesses—our only witness this morning, the Chairman of the Securities & Exchange Commission, Mary Schapiro.

Without objection, Madam Chairman, your written statement will be made a part of the record. You are also recognized for 5 minutes to summarize your testimony. We will try to be a little lenient because of, obviously, the indicated interest in your statement.

So welcome to the subcommittee, and we look forward to your statement.

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

Ms. SCHAPIRO. Thank you, Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee. I appreciate the opportunity to testify today on behalf of the Securities and Exchange Commission.

When I testified before the subcommittee last year, we were just emerging from an economic crisis that threatened our financial system and the entire American economy. The markets were still trying to regain a firm footing and confidence in the institutions of government generally, and the SEC specifically was shaken.

In response, we have embarked on a conscious effort to become a more nimble and responsive regulator, updating our rules, breaking down silos, and reinvigorating our enforcement program.

I believe we have made substantial progress and have laid a strong foundation for more progress in the coming years.

My written testimony provides an overview of the actions and initiatives the SEC is taking to fulfill this mission, but this morning, I would like to briefly highlight a few.

Internally, we set out to rebuild our culture and refocus on our core mission. We hired new leadership across the agency, streamlined procedures, encouraged a culture of collaboration, and created a new division to improve our understanding of new products, trading practices, and risks.

We substantially restructured our Enforcement Division, creating specialized units to tackle the most complex types of cases, and we eliminated a layer of management, redeploying investigators to the front lines.

Similarly, our examination program, also under new leadership, is in the process of restructuring.

While the numbers can never tell the whole story, the changes are already bearing fruit. In Fiscal Year 2009, compared to the previous year, the Enforcement Division more than doubled the amount of civil penalties it obtained; more than doubled the temporary restraining orders it sought; more than doubled the number of formal orders of investigation it issued; and more than doubled the amount of funds distributed to injured investors, over $2 billion.

Further, thanks to our congressional support, we were able to upgrade our information technology capabilities. One of the first initiatives we launched was centralizing all our existing tips and complaints into a new single searchable database. We are in the midst of building an entirely new system to record and track this information for the entire agency which we expect to deploy later this year.

We are also building analysis and workload tools to better prioritize, assign, and track this information. All of this will allow us to more effectively identify valuable leads for possible enforcement actions and compliance exams. Of course, we are not just working to make the agency more investor-focused, but the rules as well.

In the past year or so, we have proposed or finalized rules designed to improve market stability, transparency, and investor protection. We have adopted rules to provide greater protections to investors who entrust their assets to investment advisers; to strengthen credit quality, liquidity, and maturity standards for money market funds; to create a stronger, more robust framework for credit rating agencies; to curtail pay-to-play practices by advisers; and we have proposed rules to provide greater disclosure about target-date funds.

We have also taken steps to improve market structure and functioning with proposals to address flash orders, dark pools, and sponsored access.

Additionally, even before the market events of May 6th, the SEC issued a concept release raising questions and seeking input to improve price discovery and strengthen market resiliency in our highly dispersed equity market. Immediately after May 6th, we acted quickly to build upon existing rules and protect investors in the process.

The Commission has approved and the markets have implemented a pilot uniform circuit breaker program for S&P 500 stocks, and we have been working to expand the program, proposing to include Russell 1000 stocks and certain exchange traded funds.

We have published for comment proposed SRO rules designed to bring order and transparency to the process of breaking clearly erroneous trades.

And we recently proposed creating a new consolidated audit trail to create a single repository of all order, trades, and quotes. This is designed to give us a comprehensive view of market activity; to aid investigations by the Enforcement Division; and to significantly expedite market reconstructions, such as that being undertaken in connection with May 6th.

And finally, we have begun to prepare for the significant implementation requirements associated with financial regulatory reform legislation. To hit the ground running, we have established a streamlined process and created interdivisional teams to address specific issues, and we are developing estimates on how best to allocate resources for the implementation effort.

I believe we have had a productive and active year. We have improved personnel and technical resources and at the same time proposed and implemented rules that will improve our financial markets, provide additional transparency, and increase investor protection and restore confidence.

We are ready and eager to build on the substantial progress and, within the framework of financial reform, work to become an even more effective agency in the year ahead.

I would be very happy to answer your questions.

[The prepared statement of Chairman Schapiro can be found on page 46 of the appendix.]

Chairman KANJORSKI. Thank you very much, Madam Chairman.

I will take the prerogative of the first questions. I certainly welcome you to the subcommittee, and I daresay it is my evaluation this will be your nicest appearance since we do not—we are not going to be here testing what happened or what breakup occurred through the years.

With that spirit in mind, and knowing how involved you were in assisting this subcommittee and the full committee in drafting the regulatory reform bill that the President will sign tomorrow, can we extend our hand of cooperation to you that as you develop your task force, your studies, and get the responses back under the new authorities placed in your hands under the bill, that we will have a very positive response and coordination between this committee and yourself?

If you run across changes that should be made or are obvious to you, but perhaps you may determine that you lack the legal authority under the various acts, then you will work very expeditiously to report to us and request that additional authority?

Ms. SCHAPIRO. Absolutely, Mr. Chairman. I actually appreciate that invitation to work with the committee as we work through many issues that are likely to arise over the course of implementation.

Chairman KANJORSKI. Today, I was asked by a reporter, what is most the important thing that the Act will accomplish? You know it is 2,400 pages, which is pretty heavy, and to a lot of Americans, they think that has to represent a lot of nonsense in a way because how can anybody compile something that is 2,400 pages that is meaningful? The fact of the matter is, as you know, we have been working on this legislation for years, and part of this legislation has been enacted several times by this committee or the Congress, and we are just now having the opportunity to put it into law.

All that being said, do you have any reservations as to some shortfalls in the existing law? Is there anything we should immediately start to work on to correct the shortfalls, one being, as was pointed out this morning, again by a reporter, on the budgetary problems? Are those budget problems somewhat restrictive for you, and could that cause you some difficulty?

Ms. SCHAPIRO. As you know, the SEC sought self-funding the way the FDIC, the OCC, the Fed and other bank regulators are funded. And that was not accomplished in this legislation. But we are extremely grateful for the flexibility that was added to the budgeting process for the SEC that will allow us to maintain a reserve fund that will help us fund some technology projects that we think will be multiyear projects, as well as having the ability to have matched funding and to present our budget to Congress at the same time we present it to the Administration. So, while it is not everything we had hoped for, it is a significant step forward, and we are very grateful for that.

Chairman KANJORSKI. I recognize that we have established a new council; that you are now a member of the Economic Stability Council. We used to have another name for it, the Systemic Risk Council. That being said, have you had an opportunity to examine that section and particularly the authority granted by what has been known as the Kanjorski amendment, the amendment that I had offered that we create the authority within that council to discipline organizations and restrict organizations' operations and powers if they pose a grave risk to the economic system of the United States? That particular council, of course, is given the authority to do many things, including to take apart existing organizations and break them down to something below the level of "too-big-to-fail." Can you give us just a short expression of what you think of that?

Ms. SCHAPIRO. Sure. I think it is an incredibly powerful tool that the Congress has given to the regulators collectively with that particular provision and more generally with respect to—I think it is called the Financial Stability Oversight Council at this point. And I know that all of the regulators are looking forward very much to getting together very soon and starting to talk about how the council will operate, how we will collect information, how we will carry out our responsibilities as a council and as well as individually under the new law. And I think we are quite humbled by the amount of authority that we have.

Chairman KANJORSKI. Thank you very much.

I see my time is about to expire.

Now, I recognize the gentleman from New Jersey, Mr. Garrett, for his 5 minutes.

Mr. GARRETT. I thank the chairman.

In opening where the chairman ended off, just along that line, I, too, hear from constituents back home saying, how could we possibly have understood that 2,300 or 2,400 page bill, and I don't think we could. And I don't think anyone who was there at 6 a.m. did. And that is probably why, I think it was Senator Dodd said, just as Speaker Pelosi said with the health care bill, we have to pass this bill in order to understand what is in it. So we will only begin to understand what is in this bill, not today, not tomorrow, but probably years down the road and then following all of the regulations that you will be promulgating as well.

And there is the problem, the lack of certainty that Chairman Frank was talking about that would be created by the bill is just the opposite; we are creating less certainty in the marketplace and investors will remain on the sidelines for an indefinite period of time as we begin to see how these rules and regulations all play out.

One of the areas I touch upon was one that we had in the hearing, I guess, the ranking member talked about we had a year ago, with regard to the Madoff situation. As you know, the SEC is siding with Irving Picard, the trustee in the Madoff litigation—liquidation, I should say, on how investors' net equity is to be calculated.

We have all heard about the SEC's having difficulty in uncovering the fraud, albeit before you got there. Should investors infer from your position that they should no longer rely on the statements issued to them by their broker-dealer, but should instead keep a running total of their net investment in order to avoid the potential of a clawback provision later on, should their broker-dealer ever be exposed in a Ponzi scheme? If so, should we put some sort of statement, a little asterisk on the statement in the future, so they understand that these statements are really not what they seem to be, and you are responsible for your own situation?

Ms. SCHAPIRO. I don't think that is what is necessary, and I don't think we should tell all investors they can't rely on the account statements they receive from their broker-dealer. The vast majority of broker-dealers operate honestly and well within the confines of the law.

Mr. GARRETT. But that is what we were telling these investors, right?

Ms. SCHAPIRO. The approach we have taken with respect to Madoff quite generally is to bring together protections that we think will help prevent, to the greatest extent possible, another Madoff from ever occurring. So, for example, contained in the Dodd-Frank bill is a requirement for broker-dealers to be audited by a PCAOB-registered accounting firm and for that accounting firm to, in fact, be overseen by the PCAOB. That will help with the issue with respect to a no-name accounting firm that is clearly not up to the task.

We at the SEC have approved rules that are in place requiring that when an investment advisor uses any kind of an affiliate to custody customer funds or assets, those have to be subject to a surprise examination by a PCAOB-registered accounting firm. And in certain circumstances, there also has to be an independent SAS 70 report given. So we have tried to build some structural protections into the system, as well as all the reforms you have heard me recite so many times about what the SEC is doing.

If I could just correct one thing you said, we did agree with SIPC that the correct calculation was a money-in/money-out net equity calculation, but we urged the court—and the court has since confirmed that reading of the SIPA law—we did urge the court to do it on a constant-dollar basis, so that earlier investors in Madoff would realize the time value of their money, as opposed to much more recent investors. The court declined—didn't deny that, but the court did not specifically take that under consideration yet.

Mr. GARRETT. And I will close. My time is going by quickly here. One, just to say that most who have come before the panel recognize that no matter what we do here, we may find ourselves in these situations down the road. And I guess that is what I am talking about, is the next investor who is in a situation like this, despite all the things we had in the past and have in the future, really has to be watching out for themselves to some extent still.

Can you just comment very briefly on what you are going to do with regard to the 404(b) situation? You and I have talked about this for the short period of gap time.

Ms. SCHAPIRO. Yes. I am happy to let you know that our exemption with respect to small issuers under 404(b) expired last month. The Dodd-Frank bill contains a permanent exemption from their having to comply with 404(b). We will make it quite clear that during that interim, we do not expect compliance with 404(b) by those companies that would otherwise be exempted under the law.

Mr. GARRETT. My time is up. Thank you.

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

Now, we will hear from the gentleman from New York, Mr. Ackerman, for 5 minutes.

Mr. ACKERMAN. Thank you, Mr. Chairman.

Madam Chairman, you certainly have a lot more on your plate than ever was anticipated before, I think, with Dodd-Frank coming into being, with the Iran sanctions being in existence already for 3 weeks. There is an awful lot that you have to do that was not initially anticipated at the time your agency was officially formulated.

I want to concentrate on the Iran sanctions. How confident are you that you will have everything in place within the framework of the timetables?

Ms. SCHAPIRO. Congressman, we are working on that right now. We share your sense of urgency that we need to deal with these matters. There are a couple of things that are required of the SEC under the Iran Sanctions Act. One is that, like the Sudan divestiture provisions that were done several years ago, we need to write rules that make it clear that an investment company cannot be sued for divesting itself of the stocks of companies that deal in Iran. Those rules are being written and I think are nearly completed, and we need to publish those and move forward, and there is some disclosure also associated with mutual funds and investment companies.

The second thing we need to focus on is the fact that, as you said in your statement, there are punitive sanctions that can be levied against companies that violate the Iran Sanctions Act. That can create material contingent liabilities that would need to be disclosed by public companies. So we need to work on how we will do our disclosure review process in that regard and how we will communicate with public companies about their obligations in that regard.

And I would say, finally, I think we could do something to help educate investors about the potential here for a company to be sanctioned under this law and face very severe sanctions and what that might mean for investments. So we need to work on some sort of investor alert.

Mr. ACKERMAN. You suddenly wind up in the national security business besides the investor protection business. And indeed, every investor now, every American investor, finds herself or himself in the national security business also and has a right to be informed, first because of their probable individual determination to protect this country and not wanting to invest in a company that invests in a country or its economy that is determined to do damage, material damage, to the United States, but also to protect their investment from becoming sanctioned because the company is sanctioned, and they are now losing money.

If a company, under the rules that you will be promulgating, is engaged in an activity that could potentially lead to sanctions, that indeed could put a potential investor's money at risk in that company. If the company is engaging in potentially, that is risky business. Is that considered, in your view, material information that has to be disclosed to investors or potential investors?

Ms. SCHAPIRO. I think our general approach would be that where there is a real chance for a company to be sanctioned under this Act, and it could create a material contingent liability for that company, that is information that would have to be disclosed. And we are working through these issues and what kind of guidance we can give specifically on them right now.

Mr. ACKERMAN. Let me cite a specific example. I am sure we are not up to this yet, but it is specific. A company such as Honeywell, Honeywell Corporation, they do substantial business with the United States Government, and all companies doing business with the United States Government, that have contracts with the government, are prohibited from doing business with Iran under the act, which puts Honeywell in that category, because they maintain a subsidiary that conducts prohibited business with Iran. Should Honeywell be required to disclose to its investors and potential investors its business that it does through its subsidiary with Iran and the potential risk that it faces from the loss of their government contracts? And should they be required in their advising potential investors and current investors that portion of their business and profits are at risk and express that as a percentage of their profits?

Ms. SCHAPIRO. I guess I would be a little uncomfortable giving any kind of definitive answer and interpreting the law vis-a-vis the facts and circumstances.

But I will tell you that we have experience through our Office of Global Security Risk of looking at these kind of issues in the context of the state sponsors of terrorism, for whom we also require certain levels of disclosure. And I would say that under that kind of analysis, where there is a subsidiary relationship that pushes us towards a view that there is maybe a material relationship, that would have to be disclosed. But I guess I would like to think about it more carefully before I opine on that particular set of facts.

Mr. ACKERMAN. Thank you, Madam Chairman.

Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Ackerman. Now, we will hear from the gentleman from Alabama, Mr. Bachus.

Mr. BACHUS. Thank you, Mr. Chairman. Chairman Schapiro, the Dodd-Frank Act creates what I would call maybe a nightmare scenario for American businesses that will have to wait for years to find out what the rules of the road are on derivatives while the SEC and the CFTC complete multiple joint rulemakings mandated by the bill. Of course, the derivatives market is a $600 trillion market, and prior to this legislation, a lot of those derivatives were between parties. They weren't cleared. My understanding is that many of these, if not all of them, will be required to be cleared through clearinghouses, or at least a great percentage of that.

Do you have any timetable with how long you think it may take to come up with these rules and regulations? I know with Gramm-Leach-Bliley and the Commodity Futures Modernization Act, it took up to 5 years to complete the joint rulemaking.

Ms. SCHAPIRO. To the extent there are actual deadlines in the statute—and there are for many of the rulemakings—it is our goal to meet those statutory deadlines while at the same time trying to have as robust a notice and comment process as we can because we recognize the Congress has entrusted to us the responsibility for fleshing out the congressional goals that are contained in the bill and that we will need lots of input from market participants, investors and others about what those specific contours of the regulations need to look like. In fact, we are meeting today with the CFTC to talk through how we might jointly conduct our notice and comment and collaboration process where people come in and tell us what they think and why they want rules done a particular way, or what the burdens and hardships are for them so that we can leverage our staff resources, and we can also move as quickly as possible at the same time to try to get as many of these rules in place as possible.

So we are committed to both speed and expedition, but also to a deliberative process that allows us, as the two agencies work together, to get to the right results so that we don't hold up the markets, and we don't cause unnecessary uncertainty.

Mr. BACHUS. Do you see any of these clearinghouses being designated as—or either of the financial market utilities being designated—or considered may be a better word as "too-big-to-fail?"

Ms. SCHAPIRO. I think what is important that came out of the bill from our perspective as a regulator of clearinghouses is that the Federal Reserve Board will really serve as a second set of eyes to help us identify the risks of the clearinghouses. And they can, in fact, determine that the SEC or the CFTC's prudential requirements are not sufficient, and then the council would step in and have a conversation and a debate and discussion about whether the prudential or other requirements have to be raised. There is no question that these will be enormously important centers of both financial stability and financial risk. But we in the CFTC both have a long history of oversight of clearinghouses, and the clearinghouses have very robust and largely successful risk management systems in place over a many year period, whether you are looking at the securities clearinghouses, the options clearinghouses or the futures markets.

So I have a pretty high level of confidence that we will be able to continue our oversight with the additional support of the Fed and the council but in a way that takes the best of what these enterprises are already capable of doing in terms of risk management.

Mr. BACHUS. The Federal Reserve does have what I would call veto power over some of your regulations, does it not? Were you the primary regulator?

Ms. SCHAPIRO. They do have the ability, if they believe that our requirements are insufficient, to work with the council, the Financial Stability Oversight Council at large. And the Council can impose upon the SEC and the CFTC or another primary regulator to adopt standards, different standards or higher standards.

Mr. BACHUS. All right. Will the Council have any regulatory supervisory duties or will they—

Ms. SCHAPIRO. No. I think that the routine day-to-day supervision continues to be carried out by the primary regulators—SEC, CFTC, OCC, FDIC.

Mr. BACHUS. Just one final question. The discount window emergency funding would be available if these clearinghouses were designated as “too-big-to-fail,” is that correct?

Ms. SCHAPIRO. I don’t believe that discount window access is contemplated, but I guess I would have to go back and look at where things landed. But emergency assistance is possible.

Mr. BACHUS. Okay. Thank you.

Chairman KANJORSKI. Thank you very much, Mr. Bachus. We will now hear from the gentleman from California Mr. Sherman.

Mr. SHERMAN. Thank you, Mr. Chairman. You have a lot of responsibilities under this new Act. Part of it is section 939(f) dealing with credit rating agencies. How dedicated are you to creating a system with regard to structured financial products so that the issuer does not select the credit rating agency?

Ms. SCHAPIRO. As you know, Congressman, I have long been interested in the idea of a wheel system or the potential for a self-regulatory organization to make the assignment of the credit rating agency to the issuer or some mechanism that tries to make the bond that creates this profound conflict of interest between the issuer, investors and the credit rating agency.

I can’t speak for the Commission, which would obviously have to vote ultimately on whatever rules we propose. But we are very committed, I can tell you, to the study that is contained in the statute that would have us study the potential for a third party selection agent of some sort, third party assignor of—

Mr. SHERMAN. Are you as dedicated to the rulemaking as you are to the study?

Ms. SCHAPIRO. Oh, absolutely. And as you know, we have done multiple levels of rulemaking even before I came to the SEC to try to deal with the conflicts of interest of credit rating agencies, the due diligence process, the problems of rating shopping, the problems of investors not being able to understand the track record and performance of particular ratings. And some of those rules have actually very recently gone into effect. We get lots more rulemaking authority under this bill, and we will—

Mr. SHERMAN. This is not just rulemaking authority. This is a statute that requires you to adopt a rule.

Ms. SCHAPIRO. Absolutely, and many of those rules within 1 year. We are keenly aware of that.

Mr. SHERMAN. This one gives you 2 years.

Ms. SCHAPIRO. The study does, yes.

Mr. SHERMAN. And then not just the study. But then you are supposed to—are you going to be back here 2½ years from now saying, "We did the study, and that is all we have to do?"

Ms. SCHAPIRO. No.

Mr. SHERMAN. Or are you going to be adopting a rule that ends this—

Ms. SCHAPIRO. I think the statute actually requires us at the conclusion of the study to go ahead and establish some sort of system for assigning ratings for structured finance products.

Mr. SHERMAN. And I am not going to micromanage exactly which system that is, although Senator Franken's amendment has details that my amendment did not have that I commend to you. Do you think you can get it done in less than 2 years?

Ms. SCHAPIRO. I will make lots of people very unhappy when I go back to the building if I were to promise that because we have so much on our plate. But we will move expeditiously. We have multiple tracks obviously that we are proceeding with. We have 20 studies to do.

Mr. SHERMAN. Let me shift to build on Mr. Ackerman's questions. Two years ago, the SEC established a Web tool to allow investors easy access to a list of companies who, in their public filings with the Commission, disclosed that they conduct business with countries who sponsor terrorism. Needless to say, the companies didn't like that, told you that it was imperfect, and you pulled the Web site. Can companies get you to abandon anything you do just by showing it is imperfect? Or you can always make it better. But is this Web site going to be back up?

Ms. SCHAPIRO. I have to tell you that this Web site was both put up and taken down long before I came to the SEC, so my understanding of it is that the way it was developed, anytime one of the State sponsor of terrorism countries were mentioned, the company's name turned up on the Web site even if they weren't, in fact, doing business in that country, but it was mentioned in passing.

So I think it was an imperfect tool. To your broader question, "Can companies get us to back down on things," I don't think that is—

Mr. SHERMAN. The real question here is, are you going to put the tool back up with or without improvements?

Ms. SCHAPIRO. I would have to look at the tool.

Mr. SHERMAN. I fear that on this one, the companies have shown you that it is too difficult to be perfect, and therefore you should do nothing, which suits them just fine.

Ms. SCHAPIRO. I think you know me well enough and the record of the SEC over the last 18 months shows that "do nothing" has not been in our vocabulary.

Mr. SHERMAN. On this one, we have no Web site. We need the Web site. And then it is up to the investor to click, go read the report, and they may say, "We have decided not to do business in Sudan because it is a state sponsor of terror."

Ms. SCHAPIRO. I would be happy to look.

Mr. SHERMAN. It is a research tool, not a device that makes the decision. Just because you Google a company's name and the word "Iran" doesn't mean Google refuses to do the search. It also doesn't mean Google is telling you what they are doing. And likewise, the Office of Global Risk Management was designed to protect investors, and I would hope that the SEC would move forward to issue regulations to ensure companies disclose activities involving state sponsors of terror. It is long past time for those regulations to be issued.

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

Mr. SHERMAN. Thank you.

Chairman KANJORSKI. Now, the gentleman from California, Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman. Yes, I was going to ask about this issue that I think you are familiar with. The Richmond Fed did an estimate, and they said there were about $25 trillion in liabilities, 28 percent of all financial liabilities that were covered by the Federal financial safety net. And basically, the concern that this raised was that such an expansion of the safety net probably has weakened a lot of market discipline.

This was back at the end of 2008 that they did their study. But they said that has to contribute to instability in the financial sector. The question really is, how can policymakers focus on credibly scaling back that safety net and making its boundaries transparent and basically thus creating, again, market discipline in the equation when the assumption becomes, "too-big-to-fail" is the way we are headed towards these large institutions.

Some of your testimony brought up some additional questions that I would ask. There has been this discussion as to whether these private firms, these equity firms or hedge funds can pose a systemic risk. They tend to be much smaller in size. They tend to be much less in leverage. They don't overleverage much compared to the bigger financial institutions. They certainly, until now, held up well during the recent financial crisis. They didn't receive any bailouts.

But as you know, the Systemic Risk Council will be able to deem a nonbank financial company systemically important. And with that designation comes that special treatment by the government, which includes a level of support, at least for those who loan to these institutions should these entities run into trouble. The counterparties, the creditors are going to anticipate that you have that government support there. We have had debate in this committee over whether this special designation will lead to a competitive advantage. We have seen studies where basically larger firms are going to be able to borrow at 1 percent less if they are deemed systemically important.

But over the years, as I said, the level of support under our financial system has grown. It has grown exponentially during the last few years. Now it is $25 trillion, apparently. And going forward, I think it is important to understand where that line is drawn and how inclusive that government backstop is. And that brings us to the question, a simple designation by the regulators that a given institution or industry will fall inside that government support system or outside can have tremendous consequence. Mr. Bachus had asked you specifically about clearinghouses, and I thought that answer was illuminating.

So I will ask you a question going to these private firms, do you believe this industry in general can pose a systemic risk? And following up on Mr. Bachus's question, do you believe a clearinghouse could pose a systemic risk? I think the clearinghouses solve a lot of transparency problems. But on the other hand, it opens up some additional problems. And lastly, I had some questions for the record that I will leave you with. But could I have your response? Thank you.

Ms. SCHAPIRO. Let me just say, we have actually been flying pretty blind about private funds and hedge funds, as they are more popularly called, because we don't even have good even basic census data about the number of hedge funds, about the extent of their activities in the market, about the impact to their trading activities, about their leverage or their governance structure or the people who are—

Mr. ROYCE. I am all for you getting to that information. But the question is, deeming them systemically significant. Are there some that you think would—

Ms. SCHAPIRO. That leads me to, I guess the response that is really not clear, whether as a whole this industry is systemically important, whether there are individual institutions that are.

Mr. ROYCE. I understand your point, but let me go to my last point. Are you worried at all about this Federal backstop and the way it keeps building and the way that it displaces market discipline?

Ms. SCHAPIRO. I am concerned about the Federal safety net, and I am concerned about market discipline. My fear is that we didn't see a lot of market discipline over the last several years, and whether that is attributable to the presence of the Federal safety net or attributable to the wishful thinking on the part of lots of people who are running businesses, I can't say. But I do think that it will be very important for the Council to consider these issues about where the lines are drawn. I agree with you.

Mr. ROYCE. Thank you.

Chairman KANJORSKI. Thank you very much, Mr. Royce. The gentleman from California, Mr. Baca.

Mr. BACA. Thank you, Mr. Chairman, and Mr. Ranking Member. Thank you for being here. As we all know, oversight and accountability has to play a major role in what is going on, and we are about ready to sign the Dodd-Frank bill that will do a lot of this. But in doing so, I would like to state that over the past decade, we have seen our staffing levels at the SEC drop below adequate standards and your technology capacity was lacking. Past funding limitations have been cited as one of the reasons for these shortfalls along, of course, with your oversight and accountability. The Dodd-Frank bill sets out a new funding process for the SEC, and while it will still be subject to congressional approval, it will be considered separate from the President's general budget request. In your view, and I state in your view, will this change do anything to ensure that the SEC's funding needs are met on a consistent basis?

Ms. SCHAPIRO. Thank you, Congressman. I do think that these steps are helpful to us for sure, and I am very grateful for them. Most importantly, the ability for us to take $50 million of registration fees and put those into a reserve fund not to ever exceed $100 million will allow us to fund some of our longer-term technology projects with certainty that if our appropriation diminishes or doesn't increase to the extent we need it to, we can at least continue those projects. Or if we operate for very long periods of time under continuing resolutions, that money will help tide us over so we don't have to shrink our staff during those periods.

So I think they are very helpful. They are not everything that we would have hoped for with self-funding but I think they are very constructive and I am very appreciative to have those.

Mr. BACA. Thank you.

Another question I have, a couple of weeks ago, there was an article in The Washington Post about the PCAOB and its effectiveness over the past decade. In my view, the Board has struggled to find its way over the past 8 years, failing adequately to assist in situations like the ones that helped cause the collapse in 2008. Currently, the positions of chairman and the two board members are vacant. In your testimony, you state that you are still asking for recommendations for candidates. Can you give us a timetable as to when you hope to have these positions filled?

Ms. SCHAPIRO. I would be happy to. One of the issues in filling them sooner was the overhang of the Supreme Court case that challenged of the constitutionality of the PCAOB, the concern that it wouldn't continue to exist. That has been resolved. The PCAOB continues to operate. A small fix had to be made as a result of the Supreme Court case. But we are now aggressively recruiting for both the chairman and two board members. We have posted a letter on our Web site seeking nominations. We have written a letter to a number of organizations and institutions asking for nominations.

It would be our hope to fill this in the fall after the appropriate background checks and vetting process interviews by the Commissioners. But it is one of our highest priorities. PCAOB must be a functioning part of the regulatory community. There are lots of international issues with which they are involved. They are getting new responsibilities under the law as well, and I view it as one of my highest priorities.

Mr. BACA. Thank you. As we look at those positions, hopefully as we fill them in, we will look at the diversity and the growth of our Nation and our country too as well and hopefully that diversity will be reflected when you look at filling those positions.

Ms. SCHAPIRO. Yes.

Mr. BACA. Thank you. I yield back the balance of my time.

Chairman KANJORSKI. Thank you very much, Mr. Baca. Now, we will hear from the gentleman from Texas, Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman. Madam Chairman, I think you obviously know, as we all do, that unfortunately our economy is still mired in almost double-digit unemployment. We have had 2.6 million of our fellow citizens lose their jobs since the stimulus bill was passed almost 18 months ago. At least when I talk to people, from Fortune 500 CEOs all the way down to small business people in my district, one overarching theme comes through—you heard me mention it in my opening statement—and that is uncertainty. The head of the Business Roundtable happens to be the CEO of Verizon. Ivan Seidenberg said, "Government is injecting uncertainty into the marketplace and making it harder to raise capital and create new businesses."

The head of the U.S. Chamber, Tom Donohue, has said, "It is a fundamental uncertainty that is holding business back." The chief economist for the NFIB, Bill Dunkelberg, had said, "Stop scaring us to death with all this stuff that is going on and settle down."

So now, as you well know, you have inherited apparently the authority and responsibility to promulgate 123 new rules, 32 studies, establish 7 new offices or committees, in addition to at least 19 SEC actions and reviews that are ongoing. Do you believe that uncertainty is adding to the level of unemployment? And if so, what can you do with the new authority and responsibility you have been granted to at least minimize the adverse impact of uncertainty on those who would otherwise bring capital into our economy to help create jobs?

Ms. SCHAPIRO. Congressman, I am really not qualified to say whether uncertainty is adding to unemployment. But I am probably qualified from my prior life to say that uncertainty isn't good for business, and sometimes even the answer they don't want is better than no answer at all. People can get on with it and get their work done. We are going to work very hard at the SEC to be as expeditious as we can in fulfilling our rule-writing mandates of which, as you point out, there are many.

At the same time, we want to make sure we hear from those people who are going to be most affected by what we do, and so that will be a tension and a balance for us, but we would like to be able to gather input to understand, what is the operational impact of this rule if we write it? How is it going to affect this particular industry participant? How it will affect these kinds of investors?

So while we work very hard to move quickly, we don't want to shortchange the process that does so much to improve the rules that the agency produces.

Mr. HENSARLING. Chairman Schapiro, I realize the bill has yet to be signed into law—and I guess my invitation to the signing ceremony is probably lost in the mail. But regardless of that, under section 925, you have new authority under collateral bars. Do you have any timetable on when you will be able to add some level of clarity to the marketplace, either that section 229(l), enhanced application of anti-fraud provisions?

Ms. SCHAPIRO. The summary of collateral bars is relatively straightforward. What it means is that if we have barred you from participation in the securities industry, you are a registered person who committed fraud while a broker-dealer, it would mean that we could bar you from becoming associated with an investment adviser as well. Because committing fraud as a broker-dealer and then being able to move over and work as an investment adviser is not really a good result.

Mr. HENSARLING. So you would think maybe in short order? With respect to a timetable?

Ms. SCHAPIRO. We may not even need a rule with respect to something like that. That may operate by virtue of the statute itself. But your point is right. There are lots and lots of rules that we have scheduled out with a very big spreadsheet, with a team of people assigned, with an individual point person responsible. We meet every week to see what our progress—

Mr. HENSARLING. So you do have a spreadsheet with a timetable?

Ms. SCHAPIRO. Oh, absolutely.

Mr. HENSARLING. Is that something you have or will share with this committee?

Ms. SCHAPIRO. We could share. The timetables come—

Mr. HENSARLING. Speaking of timetables, mine is about to run out. Quickly, I am also concerned about the standard of care that will be applied to broker-dealers as compared to investment advisers. And I am really concerned on how the application of this standard could impact kind of the traditional broker-dealer model that allows a lot of people to still have affordable access to capital markets. Do you have any insight there on how that rule may be promulgated?

Ms. SCHAPIRO. I do. As a long-time broker-dealer regulator, I understand this issue very well, I think. But I also understand that from the perspective of an investor, the services provided by an investment adviser and a broker-dealer are largely identical in many cases.

In the provision of advice, which is how the statute is limited, to retail customers, we shouldn't leave it to investors to figure out which standard of care applies in the context of that activity they are receiving. Before we write rules in this regard—and we will go through a very collaborative process—again, we are required to seek public comment. We have already written a notice, in fact, asking for public comment on the many issues that the statute lays out for us to explore with respect to how that duty works in the investment adviser world and works in the broker-dealer world. So again, we will be very consultative on this issue.

Mr. HENSARLING. Thank you.

Chairman KANJORSKI. Thank you very much, Mr. Hensarling. Now we will hear from the gentleman from Georgia, Mr. Scott, for 5 minutes.

Mr. SCOTT. Thank you, Mr. Chairman. Chairman Schapiro, last week when I was at the White House and I was sitting right in front of the President as he was signing the Iran Sanctions Act, a cold shudder sort of ran through me at that moment. And the reason for that, I am sure, was that I know the gravity of this situation, that this is, indeed, our last best hope of stopping Iran from getting a nuclear weapon short of military action and the consequences of that.

I would like to get to the nitty-gritty of how you see your role in this. So far, I think I have been able to glean, did you see your role as, first of all, making sure that companies cannot be sued for divestiture with companies doing business and sort of an education program as well? But wouldn't it make a lot of sense, Madam Chairman, right now, the President has signed the law. It is the law. And there are companies that are in violation of that law right as we speak. Wouldn't it make sense for you, as a first step moving forward, to compile that list, communicate that list out, and make sure it is available right now for investors?

Ms. SCHAPIRO. Congressman, we can certainly look at whether we can do that. I will say, the statute doesn't contain a specific line item disclosure the way the law does for conflict minerals and extractive industries and mine safety, which were three new disclosure provisions added by the Dodd-Frank bill. That said, disclosure by a company of contact with Iran that may lead to liability or punitive sanctions are something that would need to be disclosed.

So what we need to do, and we have turned our attention to, let me assure you of that, is look at whether we can put out specific guidance about the disclosure that is required under this law. And then we will look at the question of whether we can go back to the old Web site or whatever that might provide a secondary source of disclosure of activities.

Mr. SCOTT. And your interpretation of the law as it is now, don't you feel that you have that authority now to do that?

Ms. SCHAPIRO. I think we probably do. I guess I would like to confirm that with the legal eagles, but I guess we probably do have that authority to create specific line-item disclosures.

Mr. SCOTT. And under the law as you see it now, what would happen to that company if it is found to qualify for such a list?

Ms. SCHAPIRO. I guess from the perspective of the Securities and Exchange Commission, it would be a disclosure issue. Did they fail to disclose these contracts that are material to their business operations or could create a liability for them that is material, and that could potentially be a violation of the Federal securities laws which we could prosecute civilly. We have no criminal authority. And we could prosecute those civil violations.

Mr. SCOTT. And do you believe that this law, as it is written, provides you with the ample authority to do your particular job under the law to make sure that there are no violations?

Ms. SCHAPIRO. I believe it does, and I believe it is a very strong statement of our government's position with respect to Iran and I would agree with your sort of last hope.

Mr. SCOTT. And finally, do you believe this will work?

Ms. SCHAPIRO. We can make the securities disclosure work. I think that has a very chilling effect, when something has to be disclosed, on the activities that a company is willing to undertake. So I think it can be an effective tool.

Mr. SCOTT. Thank you for answering my questions on that. I think this is a very, very important effort.

Finally, let me ask you about the information, the registry that under the Dodd-Frank bill, you have to get certain information from hedge funds and private equity advisers about their trades and portfolios to assess systemic risk. What information will be obtained?

Ms. SCHAPIRO. We are required under the Act to get specific things and have records maintained with respect to assets under management, the use of leverage, counterparty risk exposures, the valuation procedures and policies that are used by the fund, their trading practices, whether they have side letters with particular investors. So it is a fairly broad range of information that has to be maintained.

Mr. SCOTT. And how will you make sure that information is transported here to Congress for congressional review?

Ms. SCHAPIRO. That we haven't really thought through, to be perfectly honest. Those records are subject to examination and inspection by the SEC. I don't know if there are provisions which would prohibit us—there may well be—from actual further transmittal. But I would be happy to get back to you on that. I just don't know how the mechanics of the statute would work on that.

Mr. SCOTT. Thank you, Chairman Schapiro. We stand with you in helping you to progress on these challenging issues.

Chairman KANJORSKI. Thank you very much, Mr. Scott. The gentlelady from Illinois, Mrs. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman. The Dodd-Frank bill requires the SEC to issue a rule with regard to the disclosure of the pay of employees ranging from, I would say, the janitor to the CEO, all employees. When do you anticipate that the SEC will implement this provision? Do you think it will be in time for next year's proxy in the spring or is that something that will be implemented in 2012?

Ms. SCHAPIRO. I can't remember honestly whether there is a statutory deadline with respect to the advisory vote on pay, but it is a relatively simple rule for us to write. The advisory vote piece is relatively simple to write. There are some complications with respect to the disclosures that are required—more complexity, I shouldn't say complications—more complexity with respect to the disclosure required, comparing the compensation of the CEO and the median compensation of employees. The say-on-pay piece, I think, having done that already for TARP institutions, we can do that relatively soon. That could probably be in place for the next proxy season, although I can't guarantee that.

I think it will take us a bit more time to structure the rules with respect to total annual comp and the ratio to median comp of employees.

Mrs. BIGGERT. I think that there are a lot of companies that are really concerned about this and the cost to calculate the median salary of all employees, particularly large companies. And at a time when we have record unemployment and when we should be promoting job growth, should we be burdening non-financial companies with such a requirement? So I would hope that—

Ms. SCHAPIRO. Congresswoman, we have heard a number of those concerns as we have met with public companies, and they have raised that issue with us. So we will do our best to work through those issues and we will fill Congress' mandate in as least costly a way as possible.

Mrs. BIGGERT. Thank you. Do you agree with the FASB statement that appears in the May 2010 FASB and focus? It is a document. And it is regarding this recently issued exposure draft on expanding mark-to-market accounting. They said, "The global economic crisis has highlighted the ongoing concern that the current accounting model for financial instruments is inadequate for today's complex economic environment." Do you believe that FASB's rhetoric is appropriate, and should FASB be making these policy pronouncements?

Ms. SCHAPIRO. FASB is responsible for writing the accounting standards, and they have, as you point out, issued an exposure draft with respect to fair value for loans and debt securities. That is out for comment right now. We are monitoring very closely that activity. They will hold a series of activities and roundtables for the public to weigh in on those issues. They are getting lots of comment letters as well. That will be done in the fall and we will stay very close to that.

Mrs. BIGGERT. But the SEC does have oversight of FASB?

Ms. SCHAPIRO. We absolutely do have oversight. But again, this is the equivalent of our notice and comment proposal.

Mrs. BIGGERT. So you will be reviewing—

Ms. SCHAPIRO. There is a distance to go here.

Mrs. BIGGERT. Okay. Thank you. There is a recent appellate court decision regarding indexed annuities. It effectively means that the SEC will have to restart the rulemaking process for these products.

Ms. SCHAPIRO. Unfortunately, we won't, because the Dodd-Frank bill does prohibit the—

Mrs. BIGGERT. This was foreclosed by the amendment adopted during the conference that would classify indexed annuities as State regulated insurance products as long as they are governed by NAIC standards.

Ms. SCHAPIRO. You are exactly right.

Mrs. BIGGERT. Does the Commission have any future plans related to indexed annuities?

Ms. SCHAPIRO. We haven't really gone beyond the words of the statute at this point. There are concerns, and I have had these for many years, about how equity indexed annuities are sold. We are very happy to work with the State insurance commissioners who clearly have the responsibility under this law to see if we can be of assistance to them. They do have a model suitability rule. They are very focused also on sales practices, so we will try to be helpful to them in this process, but we don't have any plans to re-engage on this issue, given the legislation.

Mrs. BIGGERT. Thank you very much. I yield back.

Chairman KANJORSKI. Thank you very much, Mrs. Biggert. Now we will hear from the gentlelady from New York, Mrs. Maloney.

Mrs. MALONEY. Thank you very much, Mr. Chairman, for your leadership. I welcome the new Chairman, and I congratulate her on her public service and on her new position.

The bill that we just passed, the financial regulatory reform bill, requires the SEC to conduct 100 new rulemakings and issue 12 new reports, most of which are required within the next year. And the bill also authorizes a doubling of the SEC's budget over 5 years.

But considering most of the new actions will have to be completed in 1 year, do you believe you have the necessary resources to complete the work that is required by the Dodd-Frank bill?

Ms. SCHAPIRO. We will have to double our efforts in order to get the work done that is required under the law. We are hiring right now because Congress gave us an increased appropriation last year which was enormously helpful. And over time, as we implement all of the rules, we will certainly need resource increases to examine hedge funds, to regulate over-the-counter derivatives and all of that. But I think we are prepared for the rulemaking task which is not to say it won't be hard, but we are prepared, and I think we are adequately staffed for that. But we will continue to bring people onboard.

Mrs. MALONEY. A number of private equity firms that I represent have raised this question to me. They are smaller, and they do not borrow money. They do not engage in derivatives or in other risky products. What is the concern that the SEC has? What is the threat that they see that requires them to be registered? They claim that being registered will cost them hundreds of thousands of dollars, and I think this is a debate that we often hear between larger corporations with many resources and smaller firms that are having trouble making ends meet. But if you have the prerequisite that you are not engaged in derivatives, you do not borrow money, you are only with that particular money and the equity fund, what is the threat that the SEC sees in such equity firms that would require their registration?

Ms. SCHAPIRO. I don't think that we do see a threat necessarily. Our concern was when the legislation was drafted that the hedge funds or private funds registration provision if it had multiple exemptions in it, hedge funds and others would just reorganize to fit into an exemption, and we would lose the benefit that the bill was giving us in closing this regulatory gap. We will be very sensitive, and we clearly understand that the oversight and examination of a small private equity fund is quite different in terms of our resources and attention that we will bring to it than the oversight of a large hedge fund engaged in highly leveraged and derivatives trading activities.

Mrs. MALONEY. Could you see or consider possibly two levels of registration forms, with those involved in risky derivatives or highly leveraged—having a higher standard than one that is not borrowing money or involved in derivatives?

Ms. SCHAPIRO. We can certainly look at that. Certainly to the extent they are not utilizing leverage, they wouldn't obviously maintain records on leverage and we wouldn't be examining that. But we can certainly look at what different alternatives there are.

Mrs. MALONEY. Also, regretfully, many of my constituents were harmed by the Madoff scheme, and many of them were retired teachers, firefighters, people who are now almost destitute because of that loss. So I would like to ask, since the Madoff scheme was uncovered, your IG has issued three reports about it. And the first talked about systemic breakdowns in the manner in which the SEC conducted its examinations and investigations. Can you expand on what these breakdowns were and elaborate on some of the changes that have been put in place since you have come onboard to ensure that Ponzi schemes like this do not hurt people in the future?

Ms. SCHAPIRO. Absolutely. In addition to specific rules we have done, for example, requiring the investment advisers to custody the assets of their customers with either an independent custodian or a custodian subject to a surprise exam by a registered accounting firm and the work we have done on our tips and complaints and referrals system so that we don't lose track of tips and information that come into the agency, we have done some things that go to the internal restructuring the organization.

Some of the problems highlighted by the Inspector General really go to a lack of collaboration and coordination across geographies, New York, Boston, and Washington, for example, and between the Enforcement Division and the Inspections and Compliance Examinations Division. We have new leadership in both of those areas. We have new cross-functional teams across those areas tackling the largest financial institutions. We have united the broker-dealer and the investment adviser examination function in New York so that we are not stovepiped about who is seeing what when it is two affiliated entities, as Madoff was the investment adviser and the broker-dealer.

We are really working on highlighting for employees the importance of sharing information early and often, and I think we are having some success with that. I think it is changing very much the culture of the institution. Where employees are being—in all of their examinations now do independent custody verification when they are looking at large investment advisers so that we don't rely on the word of somebody like a Madoff about how they are operating their business. And I would be happy to maybe provide more to you in writing because I could speak about this for about an hour, detailing all the changes at the SEC that were really brought about because of the Madoff failure.

Mrs. MALONEY. Thank you. My time has expired. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you, Mrs. Maloney. Now, we will hear from the gentleman from Florida, Mr. Posey.

Mr. POSEY. Thank you very much, Mr. Chairman.

Madam Chairman, I have had an interest, I guess, for as long as I have been here now in some accountability for what went wrong at the SEC with the Madoff investigation, the fact that Barrons had a cover story, I guess, exposing the scam. And still for almost a decade, the SEC made no effort to get him off the street or prosecute him. Whether it was ineptness, indifference or incompetence, I don't know, but I am still interested in knowing if and when there is going to be some kind of accountability for that. We have had scathing internal audits and external audits, and we have heard from the SEC, we are still looking at it, we are still reviewing it. There are no actions.

The last word we had is, there hasn't been one wrist slapped, one whisper of criticism, nobody has been fired or furloughed, and I am hoping that an update is going to tell me that is not true.

Ms. SCHAPIRO. Congressman, during the pendency of the Inspector General's review which came out last fall, we could not take any disciplinary action against any employee at the request of the

Inspector General. I will tell you that of the 20 enforcement employees who were involved in some way with Madoff, about 15 of them are gone. And of the 36 examination group employees, 19 of them are gone. A lot of the senior people have left the agency. We do have, under Federal law, a disciplinary process for employees, and it is complicated here because it requires that we go back and review how employees performed years ago. We can't just look at the Inspector General report and make a decision based on that. I can tell you that we have gathered and reviewed the evidence. We are complying with the requirements of the civil service laws and procedures. We have designated, as we are required to under Federal law, a recommending official for potential discipline and a deciding official, and the process is coming to a conclusion in the near future.

It does take time. And employees have appeal rights, I will say that. So even when the agency has concluded, it doesn't necessarily mean that it is over.

Mr. POSEY. And I certainly don't want people who are not guilty of misbehavior to be punished. I am all about that. But I am encouraged to know that you are telling me that we are going to hear sooner or later that there is going to be some accountability and there are going to be some consequences for allowing this guy to milk the public for between $50 billion and $70 billion.

Ms. SCHAPIRO. Yes. You are going to hear that. But let me also say that, we made sure every employee had a copy of the Inspector General's, as you say, scathing reports as well as copies of victims' letters. And I talk to employees across the agency about the importance of their reading those letters so they understand, when we do our jobs well, the kind of pain that we can prevent and why it is important for us to take the lessons of the Madoff tragedy very much to heart and how that transforms how we approach our jobs at the SEC.

I think our message has resonated. I see enormous enthusiasm and dedication for pursuing investor protection. And as I said in my opening statement, Madoff was a Ponzi scheme. We have shut down twice as many Ponzi schemes this year as in the prior year, and that is a significant change.

Mr. POSEY. Yes, it is. But what happens—it is just like Mr. Markopolos apparently went back for the second time with the second file to encourage an investigation, they blew him off and said, we have busted hundred-million-dollar schemes before. Essentially, "We don't need your help." And his is so unprecedented. On another note—and I will look forward—I hope, Mr. Chairman, we will call a special meeting when we have a final outcome here and we know what accountability there is going to be for that misbehavior.

Are there any plans right now to investigate recipients of bailout money in the same or a similar manner that Ken Lay was investigated for shafting all the Enron stockholders? We have some big, big companies, and there is a lot of public perception that their executives did the same thing that Ken Lay did, but they have not been brought to justice yet. Are there currently plans to pursue these investigations?

Ms. SCHAPIRO. Absolutely. And Congressman, we filed a case just a couple of weeks ago that is referenced in my written testimony where the case was brought against a TARP recipient. It was actually fraud in the receipt of TARP funds. We are working very actively with the Special Inspector General for TARP as well as with the Justice Department and others. And I can tell you for all the financial regulators, it is a high priority to look for fraud in that area.

Mr. POSEY. I am thinking about the pre-req activities. I am thinking about cashing out multimillion dollar bonuses when they knew the ship was on its way down, and now the government and other taxpayers having to carry that burden for them. Are we going back and doing a forensic audit of some of this stuff?

Ms. SCHAPIRO. Yes. I can tell you we have a number of investigations under way that relate to major financial institutions, some of which received TARP money at one time or another and others that didn't. But we also have brought cases against, for example, Angelo Mozilo at Countrywide, officers of Beazer Homes, some of which include insider trading charges as well. So we have actually done a fair number of cases coming out of the financial crisis. They don't all get lots of attention, but the record is there.

Mr. POSEY. I will be wanting to follow up on that as we move forward. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you, Mr. Posey. The gentleman from Colorado, Mr. Perlmutter.

Mr. PERLMUTTER. Thank you, Mr. Kanjorski.

And just following up on a couple of comments that Mr. Posey made, also Mr. Hensarling, talking about uncertainty and accountability, my perspective on this is entirely different than theirs in that we need to bring certainty back into the markets. Accountability: there has to be accountability for those who would commit fraud or misrepresentations and those kinds of things. What we saw in 2008 was complete uncertainty and complete chaos, which I believe was as a result of certain policies of the Bush Administration and an approach which basically took the cops off the beat, meaning the SEC not enforcing the rules and regulations and laws that were on the books.

This country suffered a terrible financial trauma that is going to take years for us to recover from. But at least—and just looking at the end of 2008 compared to today—business profits are up almost 100 percent. Jobs are up from the bottom when we were losing 780,000 jobs per month the last month of George Bush, and the wealth of everyday Americans has gained from dropping 25 percent—we have gained about a third of that back, and we have a long way to go.

So I do agree with Mr. Hensarling that we need to bring more certainty. But obviously, the markets are responding that they want policemen on the beat, and I appreciate you, Madam Chairman, and the efforts that the SEC are taking on Ponzi schemes, on dealing with a number of other subjects that, in my opinion, had just gotten out of control under the prior Administration.

I have two questions. One deals with nanotrading, high-frequency trading, flash trading. Mr. Kanjorski and I had a hearing on this a number of months ago. You attended. What is happening from the SEC's point of view in studying or monitoring these high-frequency trades, which may or may not have played a part in that dramatic drop in the market a month and a half, 2 months ago?

Ms. SCHAPIRO. As you know, we published in January a concept released to review really all the issues surrounding our fragmented equity market structure, including a focus on high-frequency trading, the strategies that are used, the impact of high-frequency trading on the marketplace.

At the same time, we also have proposals out to ban flash orders, to sort of open up, light up dark pools of liquidity, to ban sponsored access where customers of broker-dealers can access markets directly and not go through risk management systems. And then we most recently proposed a large trader reporting system, so we could assign every large trader a unique identifier and follow their activities in the markets and then more broadly a consolidated audit trail so we can bring the many audit trails that exist in the equity markets into one and reconstruct events like May 6th much more efficiently. So we have lots of pieces in play on market structure. And I actually think that the May 6th events helped to crystallize to some extent our thinking about how we want to go forward with that. But it would be my hope that this fall, in spite of all the other things on our plate, the market structure is one we will not lose sight of because the real importance, frankly, to the capital raising function, which is so critical to the growth of our economy that our markets work well not just for long- and short-term investors but for the public companies that are desperate to raise capital.

Mr. PERLMUTTER. Can you explain to me a little bit more about the circuit breakers that you have put into place? Because one of the things we have talked about for at least 2 years or more is sort of the uptick rule, which is a circuit breaker of a certain kind. Where are you on circuit breakers? And then I want to talk to you about investment advisers.

Ms. SCHAPIRO. Sure. Circuit breakers, right after the market crashed, the exchanges and the SEC worked together to create a rule that required, if a stock moved more than 10 percent in the S&P 500 more than 10 percent in a 5-minute period, trading in that stock is halted for 5 minutes while traders are able to adjust, gather their thoughts, change their algorithms, if necessary, gather liquidity into the order books, and then the stock is reopened after 5 minutes by the primary market.

So if it is a New York Stock Exchange-listed company, the New York Stock Exchange would re-open trading. The circuit breakers have been triggered 3 times, actually, since they were put into place, and they operated just exactly as we hoped they would, stopped further cascading down of those stocks. They were all erroneous trades. They re-opened right where they were before they had the dramatic decline.

So we have now proposed to expand those circuit breakers from the S&P 500 to include the Russell 1000 and certain exchange-traded funds; and the exchanges and FINRA are working on the next step, which would be to try to capture all stocks in a circuit breaker kind of mechanism. There are other options here that we are look at closely, whether you should not be able to ever put in an order that is priced more than, say, 10 percent away from the market. And that is something we are looking at which would eliminate erroneous trades completely. But we have a full menu of things. We are working very closely with the industry to see what is doable and what is doable in a short time to help restore investor confidence and the market's function. Because frankly, after May 6th, there were a lot of people who were saying, "That is it. I am done. This is way too terrifying to see a $40 stock go to a penny in a matter of seconds and then go back to $40 in a matter of seconds."

Mr. PERLMUTTER. Thank you. My time has expired. I would like to talk to you afterwards about investment advisers and broker-dealers and the study that the SEC needs to undertake.

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

Mr. PERLMUTTER. Thank you.

Chairman KANJORSKI. Thank you very much, Mr. Perlmutter. Now, we will hear from the gentleman from Illinois, Mr. Manzullo.

Mr. MANZULLO. Thank you, Mr. Chairman. Madam Chairman, as I understand it, some investors fully participate in a transparent market process by making their stock orders available and contribute to the price discovery process. Other investors don't, they operate in dark pools, a system whereby they don't need to disclose sale or buy prices. I am wondering, what incentives does the SEC offer to encouraging investors to operate in an open and transparent trading process?

Ms. SCHAPIRO. That is a great question. That is one we are really wrestling with. Because we have this fear of the development of a two-tier market where certain orders go into dark pools and others are available to a public quotation and what is the incentive to quote in public markets if you can get a better price in the dark pools. And we actually believe that there are about 30 dark pools operating and they have about 8 percent of the trading volume. We have proposed that what are called indications of interest, which are used in dark pools, be treated as bids and offers and be required to be publicly displayed unless they are very large blocks which is the reason for upstairs trading in the first place and the reason for dark pools to have developed.

And we are also proposing that—for alternative trading systems, which execute a large volume of stock—that they have to display a much greater amount of their trading.

So it used to be if they had less than 5 percent of trading stock, they didn't have to display. We have proposed to lower that to a quarter of 1 percent. The broader question about how to incentivize people into the public records is one that we really tried to capture in our concept release and those are issues we are working through right now. There are a number of interesting ideas that we will pursue and put out for comment. But the dark pools issue is one that we are very keenly focused on because of its potential to create the two-tiered market that could disadvantage ultimately the public price formation market.

Mr. MANZULLO. So I would take it that nothing in the Dodd-Frank regulatory reform bill addresses that issue?

Ms. SCHAPIRO. I cannot think of anything that specifically addresses these kind of market structure questions.

Mr. MANZULLO. It is not there?

Ms. SCHAPIRO. Not that I know of.

Mr. MANZULLO. That is okay. It is a big bill and you probably would have been briefed it because it is obviously—I have another question unrelated to this. Some investors have taken losses because they have been "Madoff'd" under that type of a scheme. If I have it right, it is the SIPC that provides insurance up to a certain amount. But am I also correct is that it doesn't cover a 401(k) or a retirement plan but only an individual?

Ms. SCHAPIRO. The issue there, I believe, is that under the SIPA Act, the customer—under the view of SIPC at least—the customer is defined as the individual or the account at the broker-dealer. So that while a hedge fund, for example, might have an accountant or broker-dealer, each of the individual participants in the hedge fund are not viewed as customers and therefore the SIPC payment of up to $500,000 in the case of a broker-dealer that fails is only available to the fund itself, not to each of the account holders within that fund.

Mr. MANZULLO. So if you have a 401(k), if you hold it in a 401(k), as opposed to individually, you are out?

Ms. SCHAPIRO. Actually I am not sure about that specifically with respect to 401(k). I would be happy to get back to you quickly with an answer.

Mr. MANZULLO. That is fair enough. Thank you.

Chairman KANJORSKI. Thank you very much, Mr. Manzullo. I think I may have a quick answer for you there. Actually, in the comprehensive study portion that we put into the bill, there is a reference to flash trading, that study take on the parameters—

Ms. SCHAPIRO. You are absolutely correct. There is a reference to high-frequency trading in the comprehensive study that you—

Chairman KANJORSKI. Because of the short period of time between the enactment of the bill and the experience we had, really, no one had sufficient information to legislate a solution to the problem. We have had a request for just a few more questions, Madam Chairman. Because we know we do not get the benefit of your presence that often, not because you do not want to testify, but you have a few other things to do over there, I suspect, and we do not want to call you back, I am going to give the gentleman from New Jersey the opportunity for another 5 minutes.

Mr. GARRETT. So, you are going to be really busy and you have been really busy. But back in February of this year, the SEC issued an interpretative release with regard to perhaps some people would say not as important, the issue of disclosure costs associated with climate change. You had that in February. Then, we had the health care bill come out, and to the best of my knowledge, correct me if I am wrong, there was no such interpretative statement with regard to that.

Despite the fact that when some companies were—like Caterpillar and others were reissuing statements, you had the Commerce Secretary down the street being somewhat critical and you had some chairman here in this House wanting to go after these companies for what they were doing, but there was no interpretative statement there with regard to that, now we have, I guess, just recently, Bank of America, not on health care but on the bill that is before us right now, saying that what their projected cost of compliance will be. So my simple question on this is: Will you be issuing an interpretative release with regard to what we are discussing today? And that is the whole—

Ms. SCHAPIRO. It is a fair question. I really don't know the answer to that. Let me explain that with respect to the climate release, we did have investors managing more than a trillion dollars in investments ask us to petition the Commission for greater clarity on climate-related business risks and we did have the New York attorney general investigating a number of firms for inadequate disclosure of climate risk in his view.

And this was also actually on the agenda of the SEC before I even arrived. But I think it is also really important to note here that this was an interpretative release about existing disclosure obligations that we did not either opine on the existence of climate change or its causes if any, and we did not impose new requirements. I will tell you that from my private sector experience, I know that a number of companies have done a very good job with their climate related disclosure over several years. But that it is quite spotty.

But on the health care side, we have seen before the bill was passed even a number of health care companies do a good job on their disclosure already.

Mr. GARRETT. It actually wouldn't be health care companies. It would just be any companies that would be impacted by it, right? It is my fault, my time. I appreciate that. So you will be looking into it is the bottom line?

Ms. SCHAPIRO. We can certainly look at that.

Mr. GARRETT. One of the interesting things—the bill came out, and almost immediately after, you had a letter from Senators Dodd and Lincoln to Representatives Frank and Peterson with regard to an area of their interest. And that is the way that the bill will be treating an aspect of the bill that was quite controversial at the time. It is interesting that they were members of the committee who drafted the bill and their letter to Representatives Frank and Peterson came out so quickly afterwards.

So I guess my question is, do you interpret the legislation the same way that Lincoln and Dodd did, that under the legislation, under no circumstances should end users be subject to margin capital or clearing requirements?

Ms. SCHAPIRO. I think this is actually largely a question for the CFTC, quite honestly. Because under the bill, there is no exemption as an end user for a financial institution. So it is really—the end-user exemption goes to non-financial companies that are hedging a commercial production risk. Those are likely to be commodity-type products and those are not under the SEC's jurisdiction.

Mr. GARRETT. To the extent that you will be working jointly with the CFTC and regulations have to come out on these matters, what will be your interpretation or input on those discussions?

Ms. SCHAPIRO. I think we will have a serious discussion about it. I honestly don't know where we will end up.

Mr. GARRETT. So you don't have an opinion?

Ms. SCHAPIRO. I don't know what their view is at the CFTC at this point.

Mr. GARRETT. You don't know what theirs is, but you do know what your view will be even on the broader issues?

Ms. SCHAPIRO. I think we will try to arrive at a view together to the extent that we have to engage in joint rulemaking.

Mr. GARRETT. So it was ambiguous in the bill and it is ambiguous going forward?

Ms. SCHAPIRO. We will work through the issue. I would be happy to come and talk to you about it as we progress on that.

Mr. GARRETT. Another area that is somewhat ambiguous—and this is an area where I got a study actually put into the bill—surprise—and that is to deal with the fact that we have so many different aspects with the retention requirements, you have the FASB rules coming out as far as 166 and 167, the changing capital requirements that are both in the bill and also what you guys are working on with Reg AB. And we were saying you should study all this stuff to see how they all work together. Are you with me on that? So my question very briefly is, the study is going to be done because it is in the bill. So are you going to be on hold then with regard to what you all are doing with regard to Reg AB and until our studies get done so it all comes out clean and easy?

Ms. SCHAPIRO. I think that there are going to be a lot of aspects of Reg AB that are going to be subject to a joint rulemaking, among the regulatory agencies, I believe, shepherded by the Treasury Department. So while we do have our proposal outstanding, we would be receiving comments. The comment period has not even closed yet. We are obviously going to have to sit down with our colleagues in the regulatory community and see where we go from here. We understand the message is to try to get these things coordinated.

Mr. GARRETT. So you are going to sort of rely on the study to help you with that?

Ms. SCHAPIRO. The study will be important.

Mr. GARRETT. Great. Thanks.

Chairman KANJORSKI. Thank you very much, Mr. Garrett. Now, we will hear from the gentleman from Florida, Mr. Posey.

Mr. POSEY. Thank you again for the opportunity to follow up, Mr. Chairman. Madam Chairman, you mentioned that 15 of 20 investigators are no longer at the SEC?

Ms. SCHAPIRO. 15 of—I don't have all the position levels or anything like that. But 15—about 15 of the 20 enforcement employees who are involved in one way or another with Madoff over a many, many-year period off and on, are gone.

Mr. POSEY. And the others were examiners?

Ms. SCHAPIRO. Examiners, yes.

Mr. POSEY. How many examiners—

Ms. SCHAPIRO. I understand that about 19 out of 36 are gone. This isn't a science because some people touched these matters very peripherally, some people more so, some were in supervisory positions, some were quite junior. And frankly, that was one of our issues, I think with respect to the quality of the supervision of the examinations.

Mr. POSEY. Very good. The question that really begs for an answer is, where did they go? Are they working for other enforcement agencies now? Are they working for the companies they were supposed to regulate or enforce before? Are they retired and receiving pensions while the people that Madoff screwed are busted for the rest of their lives? Can we get a rundown of where they went?

Ms. SCHAPIRO. I don't know the answer to that. We do know where employees go for a period of 2 years after they leave the SEC. They are required to report where they have been employed or who they have been retained by. But I don't know that we have any right beyond that to know where they are.

Mr. POSEY. I think there is a necessity to know where they went. It is like letting a pedophile slink out the door or change neighborhoods and it makes everything okay. I think we are dealing with the same type of a problem here and I think it is important. If the people who allowed Madoff's fraud to perpetuate are now at other regulatory agencies, I think we ought to know that, and the other agencies ought to be put on notice. If they are working for a company they used to regulate, I think we ought to know that too.

Ms. SCHAPIRO. Congressman, I would like to disagree with you. These aren't bad people. In some cases, they were people who were very junior and were not adequately trained or supervised in what they were doing. In some cases, they were being pulled from one project to another project because the flavor of the day perhaps was market timing and late trading by investment companies and this is highlighted in the Inspector General's report. There are a lot of reasons the SEC failed with Madoff. And I have been highly transparent about those reasons. We have published all the Inspector General reports. We have posted on our Web site all of the actions we have taken to try to improve the agency's operations to try to prevent something like this from ever happening again. But I don't think we have to vilify these people. There are lots of reasons for this failure. Some were people who didn't do a good job, without a doubt. But we can't say that about everybody.

Mr. POSEY. There are people who are out $50 billion or $70 billion that might feel a little bit differently. Maybe they haven't had the same sensitivity classes but they think there needs to be accountability for bad conduct, misconduct, and maybe criminal misconduct. I read the audits, and as I said before, and you acknowledged, they are scathing. So the signal when nobody is held accountable for what is done, if they are allowed to quit and not be held accountable because they left, the signal is you don't have to do your job right. If you don't do your job and the taxpayers get bilked $50 billion to $70 billion, we will talk about how insensitive it could be to point a finger at anybody in the agency here; and if you just leave, everything will be okay and it will be forgotten.

Ms. SCHAPIRO. I think people paid a very large price through the Inspector General's reports. I am not suggesting that is enough. We have a disciplinary process. It is coming to a conclusion. It is pursuant to the Federal civil service rules. I agree very much in accountability, which is one reason why we have talked so much over the last year and a half about Madoff, why the Inspector General reports are out there. He was given free rein to do whatever investigation was necessary and we have been very transparent about it.

Mr. POSEY. My only point in saying that 15 of the 20 investigators who were involved in this—and stealing is stealing, even if the government is in on the job, believe it or not. Some people think that if the government is involved, it makes it okay. Stealing is still stealing, even if the government is involved in it. And I think saying that 15 of 20 of these investigators and 19 of the 36 examiners are no longer with the agency doesn't make what they did okay, and doesn't mean that they can't be held accountable. We should know where they are now.

Ms. SCHAPIRO. I agree it certainly doesn't make what happened okay. I am not sure how we hold them accountable under the law if they have left the agency and they haven't violated any law. I am happy to think that through further.

Mr. POSEY. Maybe some of the 1,200 lawyers who file 600 cases a year can find time between filing a half a case every year to research that a little bit and see how other law enforcement agencies handle that when somebody leaves a job after maybe they have embezzled money or helped somebody embezzle money, how leaving the job just doesn't change the fact that they have done something very wrong and there needs to be some accountability for it. And they have ways of bringing those people to justice in the private sector. Maybe it may seem relatively unheard of in the public sector, but in the private sector, they seem quite capable of getting people like that and bringing them to justice and holding them accountable.

Ms. SCHAPIRO. I hear you, and we will certainly think further about that. I don't know of any evidence or suggestion that anybody was embezzling at the SEC or aiding somebody knowingly embezzling if that is a suggestion.

Mr. POSEY. They certainly, they certainly by their—what would you want to call it—indifference or ineptitude let the Madoff fraud perpetuate for a decade. I think everybody with a half a brain in the financial industry knew that. That is why none of your big money managers or hedge fund managers got caught. They read the Barron's expose, front page story on what a fraud this guy is. But for 10 years, the SEC did nothing about it. You read the investigation just like I did.

And I am just saying that there needs to be consequences for that kind of behavior, and you told us that you are going to see that eventually we are going to hear some just being served in the future as you go through the proper course of doing this. But I am just making the statement that 15 people who were culpable probably to some degree, 19 of 36 who are culpable to some degree should not be unnamed or forgotten just because they left the agency. I think we need to know, as I stated, where they are, if they are with agencies they used to regulate, if they are in charge of overseeing at other agencies now where the blunder could be repeated and if they just retired and they are collecting pensions at the expense of the people who got bilked.

Chairman KANJORSKI. Mr. Posey, I yielded you 3 minutes of your time just so that you could—

Mr. POSEY. God bless you, Mr. Chairman. Thank you so much.

Chairman KANJORSKI. I do want to wind this up. I want to thank Madam Chairman for her courtesy in remaining over here for these extra questions, but I do want to—as to what Mr. Posey talked about, as you and I discussed, I believe it was yesterday, but time escapes me now, there is no natural immunity to criminal law if you work for the SEC; that is true. If there are criminal violations to the U.S. Code, they will be pursued by the Justice Department, not by the SEC, because the SEC only takes actions in a civil matter, as we all know. I do think, however, that Mr. Posey raises an interesting question, and perhaps as you are constructing the comprehensive study, that would be a good question to be posed to the studier: what could we do and what can we do to be more effective in finding or maintaining jurisdiction over employees in highly sensitive positions that could participate in or subliminally be part of a fraud or violation of the law? Maybe we could come up with—not only for the SEC but other sensitive agencies—some methodology; I would hate to find out that Homeland Security, because an employee did not act according to the highest standards and then left the agency, they were unreachable. I think that is the question that Mr. Posey is positioning.

As you construct the comprehensive study, Madam Chairman, I know you are already done with the construction of it, but seriously, if you could put some thought to it, it would be an interesting question either this subcommittee could follow up on or other committees of the House.

Ms. SCHAPIRO. I would be happy to do that. I should make it perfectly clear, if we have suspicion of illegal conduct by an SEC employee, that would be a referral immediately to the Justice Department. That would not be something that we would—

Chairman KANJORSKI. Right. As I expressed to you, there is a great hunger out there in the land for someone to be reprimanded, prosecuted, or in some way made to pay a price for extraordinarily bad judgment or activities that could border on criminality. Maybe we could cooperate together on that and utilize the comprehensive study to accomplish that. Now, that being said, and having kept you well over the witching hour of noon, we thank you for your courtesies to the committee. We look forward, as I said, to working with you in the future.

I would note that some members may have additional questions for this witness which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to this witness and to place her responses in the record. Without objection, it is so ordered. The panel is dismissed and this hearing is adjourned.

[Whereupon, at 12:20 p.m., the hearing was adjourned.]

A P P E N D I X

July 20, 2010

OPENING STATEMENT OF
CHAIRMAN PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON OVERSIGHT OF THE U.S. SECURITIES AND EXCHANGE COMMISSION: EVALUATING PRESENT REFORMS AND FUTURE CHALLENGES

JULY 20, 2010

Good morning. We meet today to consider the current performance and future plans of the U.S. Securities and Exchange Commission. When taking over the agency nearly 18 months ago, Chairman Schapiro faced considerable challenges, perhaps none greater than restoring the Commission's reputation in the wake of the collapse of sizable investment banks and the revelation of the $65 billion Madoff fraud. This massive Ponzi scheme made it undeniably clear that the Commission's examination, oversight and enforcement programs had serious weaknesses and required substantial reforms.

During her tenure and using the powers that she already had, Chairman Schapiro has pursued an ambitious results-oriented agenda aimed at protecting investors and restoring market confidence. She has shaken up the Commission's senior management. While she has already accomplished much, Chairman Schapiro also faces many more hurdles in the coming months, especially as she works to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act, which will become law tomorrow. This statute grants the Commission many new powers and endows it with significant new responsibilities.

Today, Congress will carry out its constitutional oversight mandate by closely examining what the Commission has recently done to better protect investors, facilitate capital formation, and maintain fair, orderly, and efficient markets. We will also begin comprehensive oversight of the Administration's implementation of the new Wall Street reform law. I believe that Congress must focus like a laser beam on this issue by holding regulators accountable for their performance under the landmark statute. As a result, this hearing is the first of many that I intend to hold on issues related to the new law.

Under the Wall Street reform law, the Commission will, independently and in cooperation with other agencies, write and police more than 100 new rules on issues like the sale of derivatives, the fiduciary duty of broker-dealers, the nomination of board directors by investors, and mandatory arbitration clauses inserted into securities contracts. Additionally, the law will require the Commission to complete a score of studies under very tight deadlines.

The historic agreement also subjects credit rating agencies to greater accountability through new liability standards, and the Commission will issue rules that, among other things, establish a system to prohibit issuers of structured finance products from picking the entity that provides the initial credit rating. The statute further empowers the Commission to register and oversee hedge fund managers and other private fund advisers.

Moreover, the landmark law aims to modify the structure of the agency to make it more nimble and responsive to the ever novel innovations of Wall Street. In addition to the offices and other structural reforms that it will impose, the bill contains my proposal to require an independent, external, comprehensive examination and overhaul of the Commission. This overhaul effort will ensure that a fresh look at the inner workings of the agency is taken in order to help rectify any remaining problems, and make sure that the Commission and its partners can effectively and efficiently detect and stop Wall Street fraudsters.

As we proceed today, we will undoubtedly review the recent developments that have garnered eye-catching headlines on the front pages of America's newspapers. For example, we need an update about the structural reforms put in place after the market's temporary plunge on May 6. We also need to shed more light on last week's eye-popping $550 million settlement with Goldman Sachs. I, for one, am hopeful that this legal action will be the first, and not the last, brought by the Commission against the hucksters of Wall Street who spun toxic mortgages into golden financial opportunities by hiding information or defrauding investors by other means.

In closing, I look forward to hearing from Chairman Schapiro on the reforms implemented by the Commission during the last year, its pending initiatives, and most importantly on how the Commission expects to implement the many new powers and authorities contained in the conference agreement to reform the way that Wall Street operates. Because too many Americans have lost their retirement nest eggs, we cannot rest. We must continue to work to improve the effectiveness of this important agency.

Oversight of the U.S. Securities and Exchange Commission: Evaluating Present Reforms and Future Challenges

Tuesday, July 20, 2010, 10:00 a.m, 2128 Rayburn House Office Building

Opening Statement – Congressman Ron Klein

Thank you, Mr. Chairman, for holding this important hearing, and thank you, Chairman Shapiro, for joining us today.

When you took over the reins of the SEC last year, you certainly had your work cut out for you. The SEC had taken a hard hit to its reputation, and many lapses had been exposed. I appreciate the work you have done to help restore trust and integrity in our financial regulatory institutions. Transparency and openness are one of the greatest assets of American financial markets, and it is essential that investors have confidence in our financial institutions. Investments help drive our economy, and people should be able to invest without the fear of being swindled.

However, there is one area where I feel the SEC has not adequately addressed clear failures, and that is in regard to the Madoff and Stanford Ponzi schemes. The stories of the schemes are familiar to all, and are a distinct embarrassment for the SEC, as they allowed these massive frauds to continue for well over a decade despite repeated warnings.

In regards to Madoff investors, the definition of net equity being used by the SIPC trustee does not reflect the spirit or letter of the law. Investors are entitled to full SIPC protection, and if there is not enough money in the fund then the dealers should be accessed to provide the funds. As the GAO pointed out, broker/dealers were severely underpaying for SIPC coverage for decades – as little as $150 a year. The SEC cannot allow SIPC to get away with putting the interests of industry ahead of investors. First, investors who had legitimate expectations that their securities were in their account should receive the full protection under SIPC. Second, the SIPC Trustee must be prevented from clawing back funds from innocent investors who had every right to assume that the profits they paid taxes on were legitimate.

In regards to the Stanford Financial Group investors, I understand that it is not a clear cut case for SIPC coverage. However, it is clear that the SEC and SIPC stamp of approval were placed on both the Stanford Financial Group and the statements received by investors, and these investors should receive SIPC protection. The SEC OIG recently released a report detailing the failures of the SEC in uncovering this fraud. I urge the SEC to take the OIG report into consideration when determining SIPC coverage for these investors, and seek the SEC's full cooperation to ensure justice for those who have been wronged by this crime.

It is unacceptable for the SEC to simply throw hands up in the air and act as if there is nothing that can be done to provide these Ponzi scheme victims the SIPC protection they are entitled to under the clear intent and letter of the law.

I know you have a monumental task in translating the new financial reform bill into workable rules, but this important issue also needs to be addressed promptly. We need your help in holding SIPC accountable, and I look forward to working with you to resolve these issues in the near future.

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

"Oversight of the U.S. Securities and Exchange Commission: Evaluating Present Reforms and Future Challenges"
Tuesday, July 20, 2010
by
Chairman Mary L. Schapiro
U.S. Securities and Exchange Commission

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

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

When I testified before the Subcommittee last year, we were just emerging from an economic crisis that threatened our financial system and the entire American economy. The markets were still trying to regain a firm footing, and confidence in the institutions of government generally – and the SEC specifically – was badly shaken.

Since then, we have taken significant steps to make the SEC more vigilant, sharp, and responsive, and focus the agency squarely on its core mission of protecting investors, maintaining fair and orderly markets, and facilitating capital formation. We brought in new leaders across the agency. We streamlined our procedures. We worked to reform the ways we operate. We began modernizing our systems. We set out to regulate more effectively, and we initiated a significant rulemaking agenda. While we have made real progress, there remains much work to be done.

Today's testimony will provide an overview of the actions and initiatives the SEC is taking to better protect investors, improve markets, and facilitate capital formation. In particular, it will detail the new changes in personnel, processes and technology that have been made at the Commission. I also will describe the Commission's regulatory activities over the past year, identify some of the coming challenges, and discuss the status of our inquiry into the severe market disruption on May 6, among other issues.

New Leadership, Organizational Structures, and Expertise

Over the past year, the Commission has undergone significant changes. These include hiring new leadership to run the agency's four largest operating units: the Division of Enforcement, the Office of Compliance Inspections and Examinations (OCIE), the Division of Corporation Finance, and the Division of Trading and Markets. We also have selected a new General Counsel, Chief Accountant, head of the Office of Investor Education and Advocacy, and directors for the New York, Miami, and Atlanta regional offices. Most recently, we hired the agency's first Chief Operating Officer. The efforts of these new senior managers, together with the efforts of other leaders who are continuing their service, are already making the SEC a more nimble, responsive, and innovative agency.

This new leadership team is committed to a culture of collaboration, information exchange and idea sharing. To solidify these efforts, we have established several interdisciplinary teams to focus on a host of specific issues (e.g., life settlements and the development of a consolidated audit trail). In addition, we have begun integrating our broker-dealer and investment adviser examinations and are consolidating our multi-office oversight of clearing agencies.

A principal lesson learned from the financial crisis is that, because today's financial markets and their participants are dynamic, fast-moving, and innovative, the regulators who oversee them must continuously improve their knowledge and skills to regulate effectively. In response, we have created and begun staffing a new division, the Division of Risk, Strategy, and Financial Innovation. This new division is helping to re-focus the agency's attention on and response to new products, trading practices, and risks. Already, we have attracted, retained and continue to recruit financial, economic, and legal experts who have a deep understanding of and experience with the financial innovations being crafted on Wall Street.

In addition, we are working to establish throughout the agency a deeper reservoir of professionals with specialized industry expertise to conduct risk analysis and identify emerging trends and practices.

Reinvigorating the Enforcement Program

Enforcement is a key element to fair and effective markets. Swift and vigorous prosecution of those who have violated the law is at the heart of the agency's efforts to promote investor confidence in the integrity of the marketplace.

Over the past year, we have improved our law enforcement capabilities. For example, we delegated to senior staff the authority to formally initiate investigations and issue subpoenas. We also ended the requirement that staff obtain Commission approval before entering into settlement negotiations involving civil monetary penalties against issuers.

In addition, we have added a host 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, and they provide new tools to help investigators develop first-hand evidence to build the strongest cases as quickly as possible.

Cooperation and coordination with criminal authorities and other regulators also has been strengthened. The SEC historically has had a very close and cooperative working relationship with criminal and other regulatory authorities. Last November, as part of the effort to better combat financial crime and mount a more organized, collaborative, and effective response to the financial crisis, the SEC joined the Department of Justice, the Department of the Treasury, and the Department of Housing and Urban Development in announcing the interagency Financial Fraud Enforcement Task Force (Task Force). The Task Force builds upon the efforts already underway to combat mortgage, securities, and corporate fraud by increasing coordination and fully utilizing the resources and expertise of the government's law enforcement and financial regulatory organizations.[1]

A little over a year ago, Robert Khuzami, a longtime federal prosecutor who had served as Chief of the Securities and Commodities Fraud Task Force of the U.S. Attorney's Office for the Southern District of New York, joined the SEC as the Director of the Division of Enforcement. Under his leadership, we undertook the most significant structural reforms of the enforcement program since 1972 – reforms designed to maximize resources and enable us to move swiftly and vigorously against securities fraud.

As part of the now completed reorganization of the Enforcement Division, we created five new specialized units, as well as a new office dedicated to the handling of complaints, tips, and referrals; we eliminated an entire layer of management, returning talented and experienced lawyers to front-line investigative work; and we hired additional, experienced staff, as well as restructured current staff to fill the various positions. Division management teams and staff around the country have worked together to make the transition smooth and effective while continuing to bring high quality cases that serve our mission of investor protection.

Highlights of the initiatives include:

Specialization. The five new national specialized investigative groups dedicated to high-priority areas of enforcement are Asset Management (hedge funds and investment advisers), Market Abuse (large-scale insider trading and market manipulation), Structured and New Products (various derivative products), Foreign Corrupt Practices Act violations, and Municipal Securities and Public Pensions. The specialized units 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. Each of the specialized units is in the process of hiring additional professionals with specialized experience to assist in investigative and enforcement efforts.

Management Restructuring. The Division has adopted a flatter, more streamlined organizational structure under which it has reallocated a number of staff who were first-line managers to the mission-critical work of conducting front-line

[1] In addition, on March 2, 2010, the Commission signed a Memorandum of Understanding (MOU) with the Internal Revenue Service designed to improve compliance rules and regulations related to municipal securities. The two agencies agreed to work more closely to monitor and regulate the municipal bond market, and discuss industry trends of mutual interest to both the IRS and the Division of Enforcement.

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. The Division also has hired its first-ever Managing Executive, who is creating a business management network throughout the Division that is focused on the Division's administrative, operational, and infrastructure functions, thus freeing up valuable investigative resources for mission-critical work.

Office of Market Intelligence. The Division has established an Office of Market Intelligence, which serves as a central office for the handling of complaints, tips, and referrals that come to the attention of the Division; coordinates the Division's risk assessment activities; and supports the Division's strategic planning activities. In short, this office gives the Division the ability to have a unified, coherent, coordinated response to the huge volume of complaints, tips, and referrals we receive every day, thereby enhancing the Division's ability to open the right investigations, bring solid cases, and more effectively protect investors.

As we move forward, we will continue to assess, evaluate, and make further improvements to the program as necessary to maximize the effectiveness and responsiveness of the Enforcement Division.

The Enforcement Division's work has increased in both speed and effectiveness. For example, in 2009, we secured orders for disgorgement and civil penalties in amounts that exceeded the fiscal year 2008 amounts by 46 percent and 101 percent, respectively. We also sought more than twice as many temporary restraining orders to halt ongoing fraudulent conduct, and issued more than twice as many formal orders of investigation. As we move forward, the Division will continue to expeditiously investigate and bring high quality cases that serve important programmatic and investor protection objectives.

Of course, we recognize that numbers alone do not and cannot capture the complexity and range – or the importance – of the actions brought by the Commission. For example, the Commission has brought a number of cases involving issues surrounding the financial crisis, including cases alleging accounting and disclosure violations at subprime lenders, misrepresentation of complex mortgage securities as appropriate for retail investors seeking safe financial products, fraud in connection with synthetic CDO marketing materials, and misleading fund investors about fund exposure to subprime investments. Our cases have included actions against American Home Mortgage, officers of Countrywide Financial Corp., New Century, Brookstreet Securities, and Morgan Keegan. And just last week, we announced a settlement in the Goldman, Sachs & Co case. Goldman, Sachs & Co. will pay $550 million to settle the Commission's charges that Goldman misled investors in a subprime mortgage product just as the U.S. housing market was starting to collapse. Of the $550 million to be paid by Goldman in the settlement, $250 million would be returned to Deutsche Industriebank AG and Royal Bank of Scotland N.V. through a Fair Fund distribution and $300 million would be paid to the U.S. Treasury. As part of its settlement, Goldman also acknowledged that its marketing materials for the subprime product contained incomplete information and agreed to tighten internal controls and assess the roles and responsibilities of Goldman personnel to ensure that disclosures in future offerings of mortgage securities are full and accurate. In agreeing to the settlement, we also took into account that Goldman is engaging in a broad-based self-assessment of its overall business practices that will increase transparency, evaluate and remediate conflicts, and reduce the chances that investors in the future will be misled. The settlement is subject to approval by the Honorable Barbara S. Jones, United Sates District Judge for the Southern District of New York. Meanwhile, the SEC's litigation continues against Fabrice Tourre, a vice president at Goldman.

In addition, in the last several months, SEC has filed other actions related to mortgage securities, including:

- Charging investment adviser ICP Asset Management LLC and others in connection with conflicts of interest and fraud concerning its simultaneous management of multiple CDOs, managed accounts and an affiliated hedge fund as they came under pricing and liquidity pressures in 2007.

- Charging the former chairman of major mortgage lender Taylor, Bean & Whitaker with orchestrating a large-scale securities fraud scheme and attempting to defraud the U.S. Treasury's Troubled Asset Relief Program. This action was brought in coordination with other members of the newly created Financial Fraud Enforcement Task Force.

- Charging Boston-based State Street Bank and Trust Company with misleading investors about their exposure to subprime investments while selectively disclosing more complete information only to certain favored investors.

Another key priority is the return of monies to harmed investors under the Fair Funds provisions of the Sarbanes-Oxley Act of 2002, which authorizes the Commission to distribute civil penalties with disgorgement funds. In fiscal year 2009, the Commission distributed to injured investors an estimated $2.1 billion, a more than two-fold increase in comparison to fiscal year 2008. During the current fiscal year, we already have distributed to injured investors an estimated $1.5 billion plus from 29 separate funds. Recent examples of where the SEC's actions have resulted in significant recovery for harmed investors include:

- Charging the investment adviser for the Reserve Primary Fund with failing to properly disclose to investors and trustees material facts relating to the Fund's liquidity and share value in the wake of the bankruptcy of Lehman Brothers Holdings, Inc. We also charged the adviser with misrepresenting that it would provide the credit support necessary to protect the $1 net asset value of the Primary Fund when, according to our complaint, the adviser had no such intention. In bringing the enforcement action, the SEC also sought to expedite the distribution of the fund's remaining assets to investors by proposing a pro-rata distribution plan, which the Court has approved. At the fund's next distribution, which the Fund is processing for distribution this week pursuant to court order, investors will have been provided with approximately 99 cents on the dollar.

- Completing the distribution of more than $178 million to investors affected by improper market timing by Millennium Partners and its related entities.

- As a result of the State Street Bank and Trust Company action referenced above, more than $300 million will be distributed to investors who lost money during the subprime market meltdown.

In addition to the significant cases we have brought arising out of the financial crisis, we have continued to bring cases in many other important areas including:

- In a pension fund pay-to-play case, we filed a settled action against a private investment firm, Quadrangle Group LLC, and one of its affiliated entities, charging them with participating in a widespread kickback scheme to obtain investments from New York's largest pension fund.

- In the municipal securities arena, we filed settled fraud charges against J.P. Morgan Securities for its alleged role in an unlawful pay-to-play scheme in Jefferson County, Alabama. J.P. Morgan paid $50 million directly to Jefferson County, forfeited more than $647 million in claimed termination fees, and paid a penalty of $25 million. At the same time, the SEC also charged two of J.P. Morgan's former managing directors with fraud arising out of this scheme and previously charged others, including the former Birmingham mayor – who in March was sentenced to 15 years in prison and fined $360,000 – a J.P. Morgan banker, and the local operative who served as go-between.

- In the area of accounting and financial fraud, auditor Ernst & Young LLP paid an $8.5 million settlement – one of the largest ever paid by an accounting firm – and six current and former partners were sanctioned for their conduct in the audit of Bally Total Fitness Holding Corporation, including abdicating their responsibility to function as gatekeepers while their audit client engaged in fraudulent accounting.

- In the Galleon and Cutillo insider trading cases, we charged more than a dozen hedge fund managers, lawyers, and investment professionals in two overlapping serial insider trading rings that collectively constituted one of the largest insider trading cases in Commission history. In the parallel criminal prosecutions, twelve individuals have already pled guilty and nine additional individuals have been indicted.

- Finally, last month, we obtained an emergency asset freeze against two Canadians we charged with fraudulently touting penny stocks through, among other venues, social media websites. The method of communication – including social media websites and text messages – was a twist on traditional fraudulent conduct and is an illustration of the Enforcement Division's responsiveness to developing technology and trends.

Strengthening Examinations and Oversight

Strong regulation is essential to the fair, orderly, and efficient operation of markets. A vigorous examination program can not only reduce the opportunities for wrongdoing and fraud, but also provide early warning about emerging trends and potential weaknesses in compliance programs. Over the past year, we have begun reforming OCIE in response to ever-changing Wall Street practices and lessons learned from the Madoff fraud.

In January 2010, Carlo di Florio, a national leader in corporate governance, enterprise risk management and regulatory compliance and ethics, became the new director of OCIE. He also has extensive experience investigating corporate fraud, corruption, conflicts of interest and money laundering. Under his leadership, OCIE has instituted a new governance structure with an emphasis on consistency in policy, program, and deployment of risk-focused strategies to target limited resources to mission critical objectives. OCIE also recently completed a rigorous self-assessment process to determine where additional opportunities exist to strengthen our exam program. Reforms to be implemented include:

- Placing greater reliance on risk assessment procedures and techniques to better identify areas of risk to investors, including working closely with our Division of Risk, Strategy, and Financial Innovation to develop better risk assessment algorithms and expanding risk-based scoping prior to exams;

- Outlining a new "open architecture" system for staffing exams that will enable management to reach across disciplines and specialties to better match the skills of examination teams to the business models and risk areas of registrants;

- More rigorously reviewing information about firms before sending examiners out to the field so that we can use our limited resources more effectively and target those firms with the greatest risks;

- Enhancing the training of examiners and re-focusing on basics such as exam planning, tracking, and accountability;

- Creating a sharable database of information on registrants of mutual interest to Enforcement, OCIE, and other regulators; and

- Redesigning our exam team structure to ensure that managers spend additional time in the field at registrants.

We also have strengthened processes requiring examiners to routinely verify the existence of client assets with third-party custodians, counterparties, and customers, and developed procedures to evaluate compliance with the Commission's new rules to fortify custody controls of an investment adviser's client assets.

Improving the Audit Follow-Up Process

The SEC has made it a top management priority to strengthen the agency's program for ensuring appropriate and timely follow-up on audit recommendations, including those from the agency's Office of Inspector General (OIG). We are committed to independent audits and have been improving our audit follow-up process, completing action on OIG recommendations at an increased pace, and providing additional resources to the OIG.

Last year, with the assistance of the SEC's Inspector General, we drafted and approved a new internal rule to strengthen controls and accountability over audit follow-up activities. Among other things, as a way of ensuring consultation with the OIG through the audit follow-up process, the rule requires that offices share with the OIG a formal corrective action plan for all resolved audit recommendations. We also appointed an Audit Follow-up Official and empowered her to ensure that agency managers are held accountable for timely and appropriate follow-up on OIG recommendations.

With these efforts, the agency has made significant progress to address recommendations made in OIG reports. In the past 18 months, the SEC has completed corrective action on more than 300 OIG audit and investigative recommendations. This is a rate of activity that is more than double that of the preceding 18 months, during which time the agency completed 135 OIG recommendations.

We have made it a particular priority to ensure that the agency undertakes all necessary actions in response to lessons learned from the agency's handling of the Madoff fraud. To date, SEC divisions and offices have now completed corrective action on 65 of the 69 recommendations that the OIG made last year in his Madoff reports. Currently, the OIG has concurred in the closure of 31 of these recommendations, and is reviewing documentation provided to support closure of the other 34 recommendations.

Actions Taken in the Wake of the May 6 Market Disruption

We have taken a number of actions to strengthen the markets since the severe market disruption on May 6. The extreme volatility on that day revealed both gaps and weaknesses in some aspects of the current structure of financial markets with respect to preventing temporary liquidity failures. Such failures occur in individual stocks when a surge in demand for liquidity, whether to buy or sell, far outstrips the provision of liquidity that is immediately available to meet such demand. The resulting liquidity imbalance causes prices to decline or rise precipitously, only to reverse just as quickly when additional liquidity become available. These types of disruptive price moves lead to further trading uncertainty, which can trigger yet more volatility, and can erode investor confidence in the integrity and fairness of the U.S. financial markets.

Beginning immediately on May 6, the SEC and CFTC launched an intensive effort to analyze and understand the behavior of the markets for securities and securities-related products on that day, and our effort is continuing unabated. At the SEC, a cross-agency task force was formed specifically to handle the inquiry that consists of staff from the Divisions of Trading and Markets, Risk, Strategy, and Financial Innovation, Investment Management, Enforcement, and OCIE. Many task force personnel have been working full-time on the inquiry since May 6. In addition, the task force meets on a weekly basis to share and aggregate information across divisions and offices, and to plan for the upcoming week's research and interviews.

Assisting the SEC and CFTC in their efforts is a newly-formed Joint Advisory Committee, comprised of two Nobel Prize winning economists, three former CFTC or SEC Chairmen, and other distinguished experts. Within two weeks of May 6, the staffs of the CFTC and SEC released a joint report to this Advisory Committee on their preliminary findings and on areas for further analysis. Since then, SEC staff has undertaken the reconstruction of the key events and metrics on May 6, so that cross-market patterns can be detected and the behavior of stocks or traders can be analyzed in detail. Reconstructing even just a portion of the market on May 6 requires aggregating and calibrating data from dozens of different sources to ensure our analysis yields consistent and meaningful results. This process has consumed a significant amount of SEC staff resources as the data are voluminous, and include hundreds of millions of records comprising an estimated 5 to 10 terabytes of information. On May 6, there were over 17 million trades between 2:00 p.m. and 3:00 p.m. alone. Overall, the markets processed 10.3 billion shares in NYSE stocks alone that day. By contrast, the key day in the 1987 Market Break Study involved a trading session processing a little over 600 million shares in NYSE stocks.

In parallel with this ongoing work, the Joint Advisory Committee has held two public meetings. In the second of these, the Committee began a process of hearing from representatives and experts from a wide range of market participants, including exchanges, brokerage houses, issuers, and institutional traders, to hear their views and insights on the events of May 6. We expect to hear from more market participants, including representatives of retail investors, in the near future. The Joint Advisory Committee also has formed two separate subcommittees that meet with the staff of the SEC and CFTC on a periodic basis to discuss the staffs' latest findings and suggest areas of further inquiry. The Advisory Committee's work already has generated valuable avenues for analysis that have assisted the staffs in their efforts to analyze and understand the market dynamics of that day.

The SEC staff's research and investigations have so far been based on a two-prong approach. We have made significant progress in collecting and assembling a massive amount of order and trade data in order to reconstruct the details of some key aspects of May 6, including the trading patterns of select stocks, the provision of liquidity by various participants, and the ways in which different types of orders were executed. At the same time, we have held extensive interviews with a variety of significant market participants to understand in detail their individual approaches to trading on May 6, how their different systems interacted with the markets, and how they responded before, during, and after the market disruption.

Between 2:00 p.m. and 2:30 p.m. the market exhibited significant selling pressure, an increase in volatility, and a thinning of order books. Starting at 2:30 p.m. these pressures accelerated and major market indices began a rapid decline.

At 2:45 p.m., events began to cascade in a number of inter-related ways. First, the sharp decline in the E-Mini and other index-based products triggered pauses or complete shutdowns in various automated trading systems (used by market makers and other large participants) as the integrity of prices undergoing such rapid changes were questioned. Second, automated trading systems were overwhelmed with market data and transaction reports causing internal latencies and self-imposed pauses or shutdowns. And third, latency issues with external systems and feeds reportedly caused confusion in quoting that also triggered pauses in some automated trading systems of large market participants, including high frequency trading firms.

As a number of large market participants either paused or shut down their automated systems, remaining orders caused yet further pressure on systems that were still in place leading to a vicious cycle. At that stage, even market participants who increased their trading activity and provided further liquidity were not able to withstand the continued increase in selling pressure.

As market participants withdrew, spreads rapidly widened, and at various points in time and for different securities a complete lack of market participants resulted in exchanges executing at automated stub quotes[2] (some at a penny or less). When marketable sell orders, likely triggered by stop-losses, found no buyers to offset the transaction, trades were automatically executed at these very extreme prices.

As noted in the Joint CFTC-SEC Staff Report of May 18, exchange-traded funds (ETFs) were disproportionately affected during the May 6 disruption. The pattern of events just described suggests why this would be the case. First, ETFs are often used to hedge individual stock transactions, and might therefore exhibit even more concentrated selling pressure than an individual stock. And second, since ETFs are comprised of a basket of individual stocks, large moves in one or two stocks can trigger pauses in automated ETF trading systems as the integrity of those prices are checked.

The one common element to all of these issues is time: market participants did not have enough time to absorb the sudden increase in selling pressure, systems were sometimes not able to keep up with the order flow, and humans did not have enough time to check the integrity of prices and transactions. This is evidenced by the fact that once some of the selling pressure was removed and system integrity was confirmed, market participants were able to quickly re-supply much-needed liquidity and market prices rebounded to pre-disruption levels.

[2] Stub quotes are used by market makers to technically meet requirements to provide a "two-sided" quote but are at such low or high prices that they are not intended to be executed.

Accordingly, it became evident after May 6 that there was a pressing need to enhance the mechanisms that provide market participants with an opportunity to respond to abnormal price moves. Within a couple of days, we were meeting with the various securities exchanges and other self-regulatory organizations ("SROs") to craft a response. Less than two weeks after May 6, we had posted for comment proposed SRO rules that would halt trading for certain individual stocks if their price moved 10 percent in a five minute period. By June 11, the SROs began putting in place a pilot uniform circuit breaker program for S&P 500 stocks. And by the end of June, we had posted for comment SRO rules to expand the circuit breaker program to include all Russell 1000 stocks and certain exchange-traded funds.

We will continue to monitor and review the effectiveness of the pilot circuit breaker program, and I anticipate that the program or another analogous type of market mechanism may be expanded to include many thousands of equities, helping to restore investor confidence and to ensure that markets can effectively carry out their critical price discovery functions.

Another step in our response to May 6 has been to publish proposed SRO rules that are designed to bring order and transparency to the process of breaking "clearly erroneous" trades. On May 6, nearly 20,000 trades were broken – but only for those stocks that traded 60 percent or more away from their price at 2:40 p.m. That benchmark was set after the fact. I anticipate that clear and consistent rules may soon be in place to guide the SROs' actions in the future.

In addition to the new rules and mechanisms, the SEC is also reviewing a number of liquidity-related rules and practices, including:

- the use of Liquidity Replenishment Points (LRPs) and other similar mechanisms by the exchanges, in which trading in a single security can be paused on one venue even though that same security is available to trade on other venues;

- the use of self-help declarations, in which one exchange can trade through the best bids and offers on another exchange if system problems or latencies in order execution are observed;

- the responsibilities of market makers to provide two-sided quotes and the practice of using stub-quotes to fulfill those requirements;

- the linkages in liquidity provisions between different forms of the same security, such as equities, options, futures, and ETFs; and

- whether the existing market-wide circuit breakers (which were not triggered on May 6) need to be updated.

Improving Agency Systems and Management

A key element in the SEC's ability to improve its oversight of the financial markets has been the availability of needed resources to address personnel and technology needs. Between FY 2005 and FY 2009, investments in new information technology systems dropped by more than half, resulting in a growing gap between our mission and the ability of our information systems to help us accomplish it. Thanks to the resources provided by Congress this fiscal year, we have been able to begin investing in several new or improved IT projects and systems.

One of the first initiatives we launched was a strategic review of the agency's systems for reviewing complaints, tips, and investigative leads provided by whistleblowers or other sources. Having an effective process to identify the most important tips can give the agency an early jump on frauds and other violations of securities laws, help guide compliance exams, and provide important information across the agency to aid staff working to protect investors and maintain market integrity. The absence of such a system directly contributed to past failures by the agency.

We have completed the first phase of this effort, which was to centralize into a single, searchable database all our existing tips and complaints, that were previously in multiple databases. This means that complaints we receive in Chicago are now stored in the same database as complaints received in Miami or any of our other offices, and the information investors share with our investor assistance hotline can be searched alongside complaints received by our markets hotline in our Division of Trading and Markets. Additionally, we released for the first time a set of agency-wide policies and procedures to govern how all employees should handle the tips they receive.

Simultaneously, we have been working on a new intake and resolution system that will allow us to capture more information about tips and complaints. The new system will provide more robust search capabilities so that tips can be better assessed or triaged. In addition, this new system will add enhanced workflow abilities so we can track how tips and complaints are being used throughout the agency. We expect to deploy this system later this year. Meanwhile, we also are in the early stages of designing the third phase of this system, which will add risk analytics tools to help us quickly and efficiently identify high value tips and search for trends and patterns across the data.

Another key area of technology investment has been in workflow and document management systems to improve the oversight of our enforcement cases and the consistency of our inspections and examinations. These systems, along with the system described above to handle tips and complaints, are all being built on the same software platform so that information can be easily researched and shared across divisions and offices. This will enable specialists from different offices to work together on cases or for staff to perform research on similar kinds of cases and examinations in order to identify patterns and trends of abuse.

As made even more apparent by the events of May 6, the staff has been working on ways to improve our capacity to obtain and analyze enormous amounts of trading data. Some of the improvements will require rulemaking. For instance, we have proposed a new Consolidated Audit Trail in order to create a single repository of all orders, trades and quotes. This repository would integrate all the relevant trading data from all exchanges and trading centers in to a single location, allowing effective monitoring and expediting inquiries like that being undertaken in connection with the May 6 disruption.

Other improvements also are being implemented. We are adding computing capacity, both in terms of better, faster equipment and, in terms of sheer storage, increasing our ability to take in large amounts of trading and other data and analyze it. Through our Division of Risk, Strategy, and Financial Innovation, OCIE's compliance programs, the Office of Market Intelligence and specialty units in Enforcement, we are increasing our usage of systems aimed at identifying risks and potential wrongdoing in securities markets. These systems and tools have aided in the analysis of the May 6 disruption and have expanded our capabilities generally.

Another key focus has been improvements to the agency's basic internal operations -- the processes that guide our work, support our infrastructure, and determine how we are organized. In the past year, we took major steps to implement a compliance program to guard against inappropriate securities trading by SEC staff. We have acquired and deployed a computer compliance system to track, audit, and oversee employee securities trading and financial disclosures in real time, and have hired a new Chief Compliance Officer to oversee these efforts. We also are strengthening internal rules governing employee securities trading, and just last week published rules in the Federal Register that would prohibit staff from trading in the securities of companies under SEC investigation – regardless of whether an employee has personal knowledge of the investigation – and require the preclearance of all trades.

Also during the past year we hired a new Chief Freedom of Information Act (FOIA) Officer and have undertaken a comprehensive overhaul aimed at strengthening our FOIA program and our commitment to open government.

We have also brought on board a Chief Operating Officer. As I mentioned in testimony last year, this is a new position that we created to help us manage our significant rebuilding projects. Our COO will provide executive leadership in the areas of information technology, financial management, and records management, including FOIA.

In addition, we are working to strengthen our internal controls over financial reporting and remediate a material weakness in this area identified by GAO. For example, we have instituted a series of improvements to the controls over our reconciliations with Treasury records and our accounting for budgetary resources, two of the problem areas cited by GAO. This year we are conducting our first comprehensive assessment of internal controls over financial reporting, with help from outside vendors. We also have begun multi-year investments to automate manual processes, build an integrated financial system, and strengthen the security of our systems. The material weakness was driven significantly by the agency's underinvestment in this area over many years, and will not be fully fixed overnight, but we nonetheless are committed to taking the steps necessary over the long term to build strong controls.

Engaging in a Significant Investor-Focused Rulemaking Agenda

Of course, the past year also has witnessed one of the Commission's most significant rulemaking agendas. The highlights include:

Adopted:

- ***Custody Controls.*** We adopted a rule in the wake of the Madoff fraud designed to provide greater protections to investors who entrust their assets to investment advisers. The rule leverages our own resources by relying on independent, third-party accountants to confirm client assets and review custody controls in situations where the possibility for misappropriation of client assets is most acute because of the adviser's possession of, or control over, client assets.

- ***Proxy Enhancements.*** We adopted rules that require companies to provide investors with more meaningful information about the leadership structure of boards, the qualifications of board nominees, conflicts of interest, compensation consultants, and the relationship between a company's overall compensation policies and risk taking.

- ***Short Selling/Fails-to-Deliver.*** We adopted a rule that restricts short selling when a stock is experiencing significant downward price pressure. This rule also enables long sellers to stand in the front of the line once a circuit breaker is triggered and sell their shares before any short sellers. In addition, we addressed the potentially harmful effects of abusive "naked" short selling, adopting rules that require that fails-to-deliver resulting from short sales be closed out immediately after they occur. Since this rule was adopted, the number of failures to deliver securities has dropped significantly.

- ***Money Market Funds.*** We adopted new rules that will help avoid a recurrence of the serious problems exposed in 2008, when the Reserve Primary Fund "broke the buck." The rules strengthen the oversight and resiliency of these funds by, among other things, increasing credit quality, improving liquidity, shortening maturity limits, and requiring stress testing of money market fund portfolios and the disclosure of the funds' actual "mark-to-market" net asset value.

- ***Central Clearing of Credit Default Swaps.*** We took action to address counterparty risk and improve transparency in the multi-trillion dollar credit default swap market by approving conditional exemptions that allowed certain clearinghouses to operate as a central counterparty for clearing credit default swaps.

- ***Credit Rating Agencies.*** We adopted rules, and proposed others, to create a stronger, more robust regulatory framework for credit rating agencies—including measures designed to improve the quality of ratings by requiring greater disclosure, fostering competition, addressing conflicts of interest, shedding light on the practice of rating "shopping," and promoting accountability.

- ***Pay-to-Play***. We adopted rules to curtail corrupting pay-to-play practices where investment advisers are managing or seeking to manage public monies that fund state and local pension plans and other important public programs. The rules should help assure that advisers to public accounts are selected based on merit, rather than political favor.

- ***Municipal Securities Disclosure***: We adopted rules to improve the quality and timeliness of disclosure of material events related to municipal securities, such as payment defaults, rating changes and tender offers.

Proposed:

- ***Asset-Backed Securities***. We proposed rules to fundamentally revise the regulatory regime for asset-backed securities. This comprehensive proposal would revise the disclosure, reporting, and offering process for asset-backed securities.

- ***Proxy Access***. We proposed rules to facilitate the effective exercise of the rights of shareholders to nominate directors to the boards of the companies they own. If adopted, I believe this rule would increase shareholders' ability to hold boards accountable.

- ***Large Trader Reporting***. We proposed rules to create a large trader reporting system that are intended to strengthen our oversight of the markets by enhancing our ability to identify large market participants and collect information on their trades so we can better analyze the data and investigate potentially illegal trading activity.

- ***Flash Orders***. We proposed rules that would effectively prohibit all markets from displaying marketable flash orders.

- ***Sponsored Access***. We proposed a new rule that would effectively prohibit broker-dealers from providing customers with "unfiltered" or "naked" access to an exchange or ATS.

- ***Dark Pools***. We proposed rules to generally require that information about an investor's interest in buying or selling a stock be made publicly available, instead of available only to a select group operating within a dark pool.

- ***Target Date Funds.*** We proposed rules to clarify the information target date funds must provide in advertising and marketing materials so that workers investing for retirement better understand the operations and risk profile of these funds. The rules, among other things, would require a visual presentation of a fund's glidepath and a listing – adjacent to a fund's name – of the fund's anticipated asset allocation at target date.

- ***Audit Trail.*** As referenced above, we proposed a rule that would require SROs to establish a consolidated audit trail system that would enable regulators to track information related to trading orders received and executed across the securities markets.

In addition, starting this fall, Commissioner Elisse Walter will lead a series of field hearings across the country concerning municipal securities. Through these hearings, we will elicit the analyses and opinions of a broad array of municipal market participants to determine what changes – to laws, to regulation, or to private sector best practices – may be needed to better protect municipal securities investors.

SEC Resources

The financial crisis reminded us just how large, complex, and critical to our economy the securities markets have become. Over the last 20 years, the dollar value of the average daily trading volume in stocks, exchange-traded options, and security futures has grown by over 25 times, reaching approximately $245 billion a day. Yet, while the markets were growing exponentially in size and complexity during the last several years, the SEC's workforce actually decreased and its technology fell further behind. Only this year, with Congress's support, has the SEC reached the levels of staff and technology investments of five years ago. Given the fast pace of change in our markets, and the vast new responsibilities granted the SEC through the regulatory reform legislation, consistent resources over many years are essential to providing the dynamic and effective regulation our financial markets deserve.

The President is requesting a total of $1.258 billion for the agency in FY 2011, a 12 percent increase over the FY 2010 funding level. If enacted, this request would permit us to hire an additional 374 professionals, a 10 percent increase over FY 2010. That would bring the total number of staff to about 4,200.

In addition, the FY 2011 budget request proposes to spend an additional $12 million on information technology investments, focused on several key projects. A top priority, as described earlier, will be the third phase of our new system for analyzing tips, complaints, and referrals. We also intend to continue our efforts to improve the surveillance, risk analysis, and case and exam management tools available to our enforcement and examination programs. We intend to modernize our financial systems and implement a new system to handle the significant increase in the volume and complexity of evidentiary material obtained during the course of investigations. We also need tools to significantly improve the efficiency of loading, storing, and archiving the roughly three terabytes of data received per month during the course of investigations in order to improve turnaround time to staff and to contain costs.

The President's proposed FY 2011 budget included a request for $24 million to begin implementation of the President's financial reform proposal. With the specific provisions of the legislation in place, we have been working to develop estimates of the resources that will be needed to achieve the full implementation of Congress' regulatory reform mandate. While the dollar cost of full implementation will depend greatly on the effective date of new rules, the timing of hiring, and other factors, we currently estimate that the SEC will need to add approximately 800 new positions over time in order to carry out the new or expanded responsibilities given to the agency by the legislation.

The Dodd-Frank regulatory reform legislation contains a number of reforms to the SEC's funding structure. For example, the language links the SEC's appropriation with the fees the agency collects, so any increase or decrease in the agency's budget would be matched by a rise or fall in fee collections. The legislation also creates a Reserve Fund for the SEC, and requires the agency to submit its annual budget requests concurrently to the Administration and Congress. I believe this new overall structure will be tremendously helpful for the SEC: to cover emergency needs that arise in the middle of a fiscal year; to help pay for multi-year initiatives, particularly new systems; and to make sure our fees are properly aligned with our budget.

Managing Agency Growth

While the budget request anticipates significant growth in the size of the SEC, the agency is properly positioned to implement this plan. To accomplish the hiring of hundreds of new staff during the course of FY 2011, the SEC is enhancing its human resources staff and, consistent with its current authorities, streamlining its hiring process. Improvements include simplifying the application process and maintaining a searchable database of applicants, so that it is possible to interview for a vacancy as soon as it appears rather than having to go through the lengthy posting process each time. Being able to better tailor, target and speed recruiting will enhance the quality of applicants and help the agency acquire the necessary talent to perform effectively in an increasingly complex financial environment.

Oversight of the PCAOB and FINRA

The Sarbanes-Oxley Act established the Public Company Accounting Oversight Board (PCAOB or Board) under the comprehensive oversight of the Commission to supplement the Commission's role in overseeing auditors. The PCAOB serves a critical role in promoting investor protection and audit quality. In the seven years since the Commission declared the PCAOB operational, the organization has moved from start-up to a fully functioning regulator, including registering over 2,400 audit firms, more than 850 of which are subject to the PCAOB's inspection program. I am pleased that the Supreme Court has determined that the Board's operations may continue and the Sarbanes-Oxley Act, with the Board's tenure restrictions excised, remains fully in effect. We look forward to continuing to work with the Board in connection with its ongoing mission to oversee auditors in order to protect the interests of investors and to improve audit quality.

The SEC's oversight of the PCAOB includes responsibility for appointing the Chair and members of the Board. Currently the position of Chair and two members of the Board need to be filled, and we are soliciting recommendations for qualified candidates. The law states that Board members shall be "appointed from among prominent individuals of integrity and reputation who have a demonstrated commitment to the interests of investors and the public, and an understanding of the responsibilities for and nature of the financial disclosures required of issuers under the securities laws and the obligations of accountants with respect to the preparation and issuance of audit reports with respect to such disclosures." In addition to the requirements of the Sarbanes-Oxley Act, we consider other desirable experience and related criteria of candidates, including experience that demonstrates a strong understanding of the role of auditors in the Commission's financial accounting and disclosure system, the ability to be a fair regulator from the viewpoint of all participants in the financial markets, a demonstrated record of independence and the ability to make unpopular decisions when necessary, and the ability and willingness to serve the full term to which they are appointed. I am committed to completing the appointment process as quickly as possible.

In addition, the SEC oversees and regulates the Financial Industry Regulatory Authority (FINRA), a securities self-regulatory organization. Broker-dealers that do business with the public must be members of FINRA. FINRA allows the SEC to leverage its examination and enforcement resources by providing front-line oversight of their broker-dealer members. The SEC staff regularly inspects the FINRA's regulatory programs to assure that it is effectively monitoring their members for potential violations of the federal securities laws and SRO rules, and properly citing broker-dealers for violations.

Oversight of SIPC

The Commission continues to oversee the activities of the Securities Investor Protection Corporation (SIPC), which plays a critical role in protecting the customers of a broker-dealer entering liquidation. The Commission may participate as a party to all liquidation proceedings brought under the Securities Investor Protection Act (SIPA). We closely monitor the active SIPA cases and participate in those we deem appropriate. For example, in the Madoff case, where liquidation has commenced under SIPA, the Commission has filed a brief with respect to key definitional issues under the Act.[3] We also are monitoring issues surrounding the R. Allen Stanford matter as it relates to SIPC.[4]

Commission staff also is participating as an observer to a task force created by SIPC to undertake a comprehensive review of SIPA and SIPC's operations and policies. The task

[3] As it relates to the Madoff liquidation, as of July 9, 2010, SIPC had determined 13,112 of the approximately 16,300 claims, allowing 2,153 claims and denying 10,959 claims. The dollar amount of the allowed claims totaled $5,530,836,371 and the amount of SIPC advances totaled $705,517,783. According to the Trustee's Interim Report filed in April 2010, he anticipates making pro rata interim distributions of the fund of customer property late this summer.

[4] In the R. Allen Stanford matter, SIPC has indicated that in its view and based on the facts presented, there is no basis for SIPC to initiate a proceeding under SIPA. The Commission is investigating the facts to determine whether that determination is appropriate, including staff meeting with the Stanford Victim's Coalition and reviewing the documents they have provided in support of their claims.

force consists of a diverse group, including industry experts, SIPA trustees, and investor representatives, and ultimately will propose reforms to modernize SIPA. The task force will review issues such as excess SIPC coverage, the adequacy of the SIPC fund, and investor education. The task force has created a website where it has invited the public to comment on these and other issues, which is available at www.sipcmodernization.org.

Coordination and Cooperation with State Securities Regulators

As the Commission pursues its investor protection mission, we recognize that our effectiveness is enhanced when we leverage resources and share enforcement and examination information with fellow regulators, particularly our fellow state securities regulators. We have close and constructive relationships with state securities regulators throughout the country. Nowhere is this more evident than in our regional offices, where our staff coordinates closely with state securities regulators regarding local broker-dealers, investment advisers and enforcement matters. Broker-dealers generally are dually registered with both the SEC and the states in which they conduct business. Broker-dealers that do business with the public also are registered with FINRA. We jointly use common electronic registration systems to register both broker-dealers and advisers. On the other hand, regulatory responsibility for investment advisers generally is divided between the SEC and the states, with an investment adviser's assets under management serving as the dividing line between SEC or state oversight, even though both SEC and the states retain anti-fraud jurisdiction over all investment advisers. Currently, the assets-under-management dividing line between SEC and state registration of investment advisers is set at $25 million. However, within a year of passage of the Dodd-Frank Act, that threshold will change to $100 million for most investment advisers, if they are subject to registration and examination in their home states. We expect to work closely with the securities regulators in the various states to implement the transition of certain investment advisers from SEC to state registration as contemplated by the Act.

Implementation Challenges of Regulatory Reform Legislation

The coming period likely will be dominated by implementing the Dodd-Frank regulatory reform legislation. Dodd-Frank in my view closes a number of regulatory gaps, gives the SEC important tools to better protect investors (including, for example, nationwide service of process in civil actions, a clarification on the scienter standard for Exchange Act aiding and abetting actions, and authority to order penalties in cease-and-desist proceedings), and adds or expands several areas of responsibility, including over-the-counter derivatives, credit rating agencies and private funds.

The Act requires the SEC to promulgate a large number of new rules, create five new offices, and conduct multiple studies, many within one year. The importance and complexity of the rules coupled both with their timing and high volume and the rulewriting agenda currently pending will make the upcoming rulewriting process both logistically challenging and extremely labor intensive.

The Act also requires the Commission to hire an independent consultant to examine SEC internal operations, structure, funding, and the need for comprehensive reform. Agency staff already have begun the initial work necessary to move forward with a formal procurement on the study, and to free up the funds needed to pay for the study we also have submitted a formal reprogramming request to the House and Senate Appropriations Committees for consideration.

In addition, the Act also contains a provision granting the SEC broad authority to reward whistleblowers. SEC staff has begun meeting internally to discuss the rules required by the legislation. The goal will be to establish a robust whistleblower program that incentivizes persons to come forward with information we would not otherwise receive and enhances the effectiveness of our enforcement efforts.

Conclusion

The SEC has accomplished a great deal in the past year. We are working to improve personnel and technical resources and at the same time are proposing and implementing changes to improve financial markets, provide additional transparency and increase investor protections. Even with the substantial progress we have made in the past year, there remains much work to do.

The SEC has a significant mission, and our responsibilities to fulfill that mission will grow under the provisions of regulatory reform legislation. We look forward to working closely with Congress to implement the new law.

Thank you again for your past support, and for allowing me to be here today to discuss the current state of the Commission. I look forward to answering any questions that you might have.

Ranking Member Spencer Bachus Questions for the Record
Securities and Exchange Commission Oversight Hearing
July 20, 2010

1. **With its vast (and often vague and ambiguous) regulatory mandates and its 2,300-plus pages of legislative text, Dodd-Frank represents a "Full Employment Act" for Washington bureaucrats and lawyers and lobbyists. Your written testimony estimates that the SEC will need to hire at least 800 new employees just to discharge the massive new regulatory responsibilities you will receive once the President signs the bill into law tomorrow. Can you understand the frustration of some of our constituents who see this as rewarding regulatory failure on a grand scale? How will adding multiple layers of bureaucracy and hundreds of new regulations and government employees contribute to a dynamic U.S. economy?**

2. **Chairman Schapiro, one of the biggest obstacles to economic recovery at the moment is the climate of regulatory uncertainty in which U.S. companies are operating, a problem that I believe is only made worse - much worse - by the Dodd-Frank Act. Unknown regulatory outcomes will undoubtedly cause market participants to either act very conservatively or not engage in the markets until the SEC issues proposed rules and exerts its new authorities. What is your work-plan to manage the more than 150 studies, reports, and rules that the SEC must promulgate in a manner and on a time-line that doesn't breed further paralysis?**

Answers to Questions 1 & 2:

As you note, The Dodd-Frank Act includes over 100 rulemaking provisions applicable to the SEC, many of which require action within one year. It also requires the SEC to conduct more than twenty studies and create five new offices. While this is a very significant task, we are committed to fulfilling our mandates under the Act, as well as our preexisting responsibilities.

We have established new internal processes and formed cross-disciplinary working groups for each of the major rulemaking initiatives and studies, and designated team leaders for each effort. Our rule writing divisions and offices are meeting weekly to review the status of rulemakings and studies and to plan for the upcoming weeks. My office and the Office of the General Counsel oversee and coordinate much of this planning effort, and all Commissioners are provided with both written weekly updates and monthly oral briefings on status.

To help the public track our progress as we take actions to implement the Act, we have created a section on our website that provides detail about our schedule for implementation, along with links to completed actions. We think this will provide a useful reference tool to both the investing public and the financial industry as we proceed with implementation. The link to the site is http://www.sec.gov/spotlight/dodd-frank.shtml. We hope this new web section will prove a valuable resource while underscoring our commitment to transparency and accountability.

As you mentioned, we estimate that the implementation of the Dodd-Frank Act will take approximately 800 new staff, because of the vast new responsibilities given to the SEC under the Act. We would aim to hire those staff over the next few fiscal years, to the extent allowable under our appropriations for those years.

I believe the Dodd-Frank Act provides the SEC with important tools to better meet the challenges of today's financial marketplace. While implementation of the Act clearly will require a major effort, this effort is already well underway at the SEC. We undoubtedly will encounter some bumps along the way, but we are on track to meet the goals, mandates and deadlines specified in the Act and to do so in a transparent and inclusive manner. As we proceed with implementation, we look forward to continuing to work closely with Congress, our fellow regulators and members of the financial and investing public.

3. **Chairman Schapiro, the failures of the SEC staff to perform their jobs have been well-documented. Equally troubling are the reports that some SEC employees spend their time engaged in non- Commission sanctioned activities. All of these failures have damaged the agency's credibility and called into question its ability to fulfill its Congressionally-mandated mission. What specific problems with the civil services laws have you encountered in attempting to discipline, re-assign or terminate SEC employees? In addition, can you please provide me in writing recommendations to help you more effectively manage the Commission's employees?**

Answer:
I have taken, and will continue to take, aggressive measures to ensure our employees are held to the highest ethical standards and are deserving of the public's trust. Any level of misuse of government resources for inappropriate purposes is a matter of serious concern, and I am determined that the reputations of the SEC's hard working professionals who are dedicated to protecting investors, and the reputation of our agency as a whole, cannot suffer because of the actions of a few individuals. For example, in April of this year, I sent an agency-wide message conveying my anger and frustration at those few individuals who had misused SEC time and resources. In that email, I emphasized that any person who violated our clear rules against this inappropriate behavior faced termination of employment.

As you are aware, Section 967 of the Dodd-Frank Act requires the SEC to hire an independent contractor to examine the organization and operations of the SEC, including the application of civil service laws. We have entered into a contract with the Boston Consulting Group to perform this study, and Section 967 requires that the contractor complete its work and issue a report to Congress and the SEC Chairman in March 2011. We look forward to working with Congress as we implement any recommendations of this study.

4. **Chairman Schapiro, section 991 of the Dodd-Frank bill increases the Commission's funding over the next five fiscal years and creates a new $100**

million reserve fund that can be spent *"as the Commission determines is necessary to carry out the functions of the Commission."* Many of the Commission's failures were not the result of a lack of funds, but rather an inability by the staff to use its existing authorities wisely and effectively. How do you plan to use this reserve fund?

Answer:
Although Section 991 of the Dodd-Frank Wall Street Reform and Consumer Protection Act increases the authorized level of funding for the SEC, the actual level of funding will depend upon the appropriations Congress provides over the next several fiscal years. Section 991 requires that the SEC deposit $50 million in registration fees into the new Reserve Fund, starting in FY 2012. The SEC is permitted to obligate up to $100 million from the Fund in any one fiscal year, although the agency could only spend that amount in a year if it built up $50 million in balances from the prior year.

When the Fund begins in FY 2012, the SEC expects to begin using it for three main purposes. As money is deposited in the fund, the SEC anticipates using these funds to cover expenses if there is a continuing resolution in FY 2012, to lessen its impact on critical initiatives in staff hiring or other areas. The agency also expects to dedicate Reserve Fund dollars to support multi-year initiatives, such as technology projects. Examples of multi-year projects that could receive support from the Reserve Fund could include the agency's new system to handle tips, complaints, and referrals; enforcement and examination management systems; risk analysis tools; and financial management systems. Finally, the SEC expects to hold a portion of the Fund in reserve, to cover expenses during an FY 2013 continuing resolution in case that year's registration fee collections are slow in coming, or to pay for other unanticipated needs.

5. **A July 2009 New York Times article indicated that the exact cause of the May 6th market spike is still unknown and that it may have been attributed simply to an "imbalance between buyers and sellers." Can you please speak to this theory? Should we be concerned that the Commission doesn't know the exact cause of the spike?**

Answer:
On September 30, the staffs of the Commission and the CFTC issued their findings regarding the market events of May 6, 2010, in a report to the Joint Advisory Committee on Emerging Regulatory Issues. That report can be found on the Commission website at: http://sec.gov/news/studies/2010/marketevents-report.pdf. The report, which was the result of extensive data analysis and investigation, outlines in significant details the events of May 6 that culminated in the extraordinary market events of that day. We anticipate the joint SEC/CFTC Joint Advisory Committee on Emerging Regulatory Issues will make recommendations in the near future to avoid similar market events in the future.

6. **Only broker-dealers, issuers (public companies) and investment companies (mutual funds) fund the agency's operations. You and your predecessors have**

testified that the Commission regulates more than 35,000 entities. With the increased workload that the Dodd-Frank Act envisions for the SEC, do you expect that the Commission will need to identify additional funding sources and impose new fees on those entities that currently do not pay for their oversight?

Answer:
The annual appropriation to the SEC historically has been offset by the fees it collects. These fees have been of two principal types: fees imposed on public companies and investment companies for the registration of securities (which in FY 2010 accounted for about 22% of fee collections), and fees on transactions in securities (which in FY 2010 accounted for about 78% of fee collections). Any fees collected by the SEC are authorized by statute, and any additional fees would need to be authorized by legislation.

The SEC's transaction fees actually wind up covering many of the agency's registrants, albeit indirectly. The law requires that transaction fees be paid to Commission by the securities exchanges and FINRA. Under their rules, the securities exchanges and FINRA require their broker-dealer members to pay fees on sales of securities executed by them. The broker-dealer members, in turn, collect fees from persons who sell securities through them; or, if the broker-dealer members sell securities for their own accounts (proprietary trading), they pay the fees themselves. In this way, transaction fees ultimately are imposed on sellers of securities, whether they are retail investors, institutional investors like hedge funds, investment advisers, mutual funds, and pension funds, or the broker-dealer members themselves. That said, the SEC currently does not collect fees from some entities it regulates that typically do not engage in securities transactions, such as transfer agents, clearing organizations, and credit rating agencies.

Beginning in FY 2012, the Dodd-Frank Act requires the entire amount of the SEC's appropriation to be offset by transaction fees alone. The Commission will be required to set fee rates so that estimated transaction fee collections equal the amount of our appropriation. Thus, if there is an increase in the SEC's appropriation, such as to implement the agency's new responsibilities under the Dodd-Frank Act, transaction fee collections would rise accordingly. If Congress were to authorize additional fees, then any such fees would need to be integrated into the new funding mechanism established by the Dodd-Frank Act. As always, we are willing to work with Congress on any funding issues.

7. **The SEC's Division of Trading and Markets will be implementing numerous sections in Titles VII and IX in the Dodd-Frank Act. Section 916 of the Dodd-Frank Act also requires the Commission to streamline and improve the processes for approving rules submitted by self-regulatory organizations (SRO) under Rule 19(b) of Securities and Exchange Act of 1934. Do you have a plan to ensure that the Division's routine work, such as the approval of SRO rule filings, is completed on a timely basis while the Division is managing the implementation of the many Dodd-Frank rulemakings and studies?**

Answer:
The Division of Trading and Markets, on behalf of the Commission, reviews proposed rule changes submitted by SROs pursuant to Section 19 of the Securities Exchange Act of 1934 and considers such proposals' compliance with the requirements imposed on SROs by the Exchange Act. The rule filing requirement is one of the cornerstones of the Commission's oversight over SROs and provides an opportunity for the Commission and public commenters to review every SRO proposed rule change to ensure that each SRO carries out the purposes of the Exchange Act and exercises its regulatory authority appropriately.

The Commission processes a considerable number of proposed SRO rule changes, and the volume of filings continues to expand as competitive SROs more frequently amend their rules and fees and the number of SROs continues to increase. In calendar year 2009, the Commission received approximately 1,800 filings from SROs and to date we have received just over 1,500 filings in 2010. Approximately three-quarters of filings are effective upon filing by the SRO, while the remainder are subject to separate notice and Commission approval before they may become effective.

As a result of the Commission's market structure rulemaking initiatives, investigation into the market events of May 6, and the studies and rulemaking required by the Dodd-Frank Act, the Commission and its staff, in particular the Division of Trading and Markets, has seen a marked increase in its workload.

Nevertheless, the timely review and processing of SRO rule filings remains an important core function of the Division of Trading and Markets, and we are committed to ensuring the continued timely review of SRO proposed rule changes. To ensure compliance with the revised timelines, the Division has modified its internal procedures to accommodate the new process. For example, staff is in the process of finalizing systems changes to its electronic form 19b-4 filing system to monitor the new statutory deadlines and reflect the new process for handling SRO rule changes. This will allow staff to accurately track and monitor compliance with the applicable revisions to Section 19 of the Exchange Act. Further, to assist with the increased workload with respect to SRO filings and in other areas, the Division is in the process of bringing in additional staff, to the extent the agency's funding allows.

Going forward, the Division staff remain committed to ensuring the continued timely review of SRO proposed rule changes, building on a strong track record of timely processing prior to Dodd-Frank. To further facilitate the Commission's review, SROs themselves play an important role as well. A well-written proposal that complies with all applicable requirements, fully describes the proposed change, and presents a clear and reasoned legal analysis as to why the proposal is consistent with the Exchange Act greatly facilitates the Commission's review and timely publication of the proposal.

8. **The Dodd-Frank Act contains amendments to the Commodity Exchange Act and the Bankruptcy Code that clarify the insolvency regime applicable to cleared swaps. These changes also promote portability of cleared swaps by customers. Is the SEC planning to suggest comparable changes to the securities laws, the**

Securities Investor Protection Act and the Bankruptcy Code to clarify the insolvency regime for security-based swaps and Over-the-Counter (OTC) equity options that are submitted for clearing? If so, when do you anticipate that the SEC will submit legislative recommendations to the Financial Services Committee? Are security-based swaps and OTC equity options now placed at a competitive disadvantage to swaps without further clarifications to the insolvency regime and changes that would promote customer portability?

Answer:
We do believe there is a potential gap in the protection afforded to security-based swap customers of a security-based swap dealer and security-based swap customers of a dually registered broker-dealer/security-based swap dealer. The Dodd-Frank Act amended the Bankruptcy Code to protect customers in the event a security-based swap dealer files for bankruptcy. Specifically, the Bankruptcy Code was amended to define a security-based swap as a "security" and to make a security-based swap dealer subject to a stock brokerage liquidation. This means that customers would be given a preferred status over general creditors with respect to customer assets of the failed security-based swap dealer. Unlike the amendments to the Bankruptcy Code to protect customers of security-based swap dealers, Dodd-Frank did not make corresponding amendments to the Securities Investor Protection Act (SIPA) to protect security-based swap customers of a dually registered broker-dealer/security-based swap dealer. Specifically, Dodd-Frank did not amend the definition of "security" in SIPA to include security-based swaps nor did it amend the definition of "customer" to include security-based swap customers. Consequently, a person with a claim against a failed dually registered security-based swap dealer/broker-dealer based on a security-based swap may be treated as a general creditor who is not entitled to SIPA protection.

The Commission staff would be happy to provide technical assistance to address this issue.

Rep. Carolyn McCarthy questions:

What can you tell me about the available resources at the Commission, as well as the state level for overseeing advisers?

Today there are approximately 11,750 SEC-registered investment advisers and 14,500 state-registered advisers. After the implementation of the Dodd-Frank Act, we expect there to be approximately 8,500 SEC-registered advisers and 18,500 state-registered advisers. This change is attributable to two Dodd-Frank provisions. First, approximately 4,000 advisers will switch from Commission to state registration due to the reallocation of the regulation of mid-sized advisers, those with assets under management of $25 million to $100 million. Second, we anticipate that approximately 750 advisers will newly register with the Commission as a result of the elimination of the private adviser exemption that many advisers to hedge and other private funds rely on today.

During fiscal year 2009, Commission staff performed approximately 1,250 examinations of SEC registered investment advisers. These examinations were performed by approximately 450 examination staff (including field examiners, supervisors and support staff) located in our headquarters in Washington, DC and the 11 regional offices throughout the United States. The staff dedicated to these inspections is also responsible for conducting reviews of affiliated mutual fund complexes and conducted more than 300 such exams during the year.

We do not maintain data on state regulatory activities. However, in connection with a study the SEC is conducting on the obligations of broker-dealers and investment advisers, which is mandated by the section 913 of the Dodd-Frank Act, the North American Securities Administrators Association (NASAA) recently reported that the states conducted approximately 2,400 investment adviser examinations in 2009. NASAA also indicated that 47 states monitor compliance by investment advisers through examination or audits of state-registered advisers, and that the states have 230 field examiners and auditors for both investment advisers and broker-dealers. The NASAA report is available at http://www.sec.gov/comments/4-606/4606-2789.pdf.

As part of the transition process within the Dodd-Frank Act to move certain investment advisers from being regulated by the Commission to being regulated by their home state, will the Commission work with state securities regulators to encourage the adoption of on-site review and examination programs for those states who do not have one in place, and will gain a fair number of the transitioning firms?

Since the enactment of the Dodd-Frank Act we have been working with the states to ensure an orderly migration of SEC-registered advisers to state regulation. Our staff has biweekly conference calls with NASAA representatives to discuss issues that have arisen. Among other things, our staff has been discussing changes to Form ADV, Part 1, the joint investment adviser registration form of the SEC and the states. The staffs also have been discussing issues related to sharing examination information.

July 20, 2010 Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises hearing entitled "Oversight of the U.S. Securities and Exchange Commission: Evaluating Present Reforms and Future Challenges"

Questions for Record from Congressman Royce

Question 1
Why has the SEC experienced catastrophic failures over the past decade or so in every one of its four core competencies – rulemaking, filing review, enforcement and examinations?

Since 2009, we have worked tirelessly to review our policies, identify the areas in need of improvement, improve our operations and structure, and address any deficiencies.

With respect to both enforcement and examinations, we have instituted – and are continuing to institute – extensive reforms: we have brought in new leadership focused on a culture of collaboration and cooperation, reformed the structure of the Enforcement Division and are in the process of doing so for our Office of Compliance, Inspections and Examinations (OCIE), greatly expanded our training programs, hired staff with new skill sets, streamlined management, revised our enforcement and examination procedures, restructured processes to ensure better internal sharing of information, revamped the way we handle the huge volume of tips we receive annually, and improved our risk-assessment techniques so that examiners are focused on the right issues.

With respect to rulemaking, we have identified areas in need of new or updated rules, and have been engaged in a significant agenda to better protect investors. In the past year, we have adopted rules concerning custody of customer assets, central clearing of credit default swaps, money-market funds, and credit rating agencies, among others, and a number of other rules have been proposed, including those concerning asset-backed securities, a consolidated audit trail system, and large trader reporting. We will continue to address these and other issues in need of attention, in addition to promulgating those rules required under the recently enacted Dodd-Frank Act.

On filing review, the SEC's Division of Corporation Finance selectively reviews filings made under the Securities Act of 1933 and the Securities Exchange Act of 1934 to monitor and enhance compliance with the applicable disclosure and accounting requirements. As required by the Sarbanes-Oxley Act of 2002, the Division undertakes some level of review of each reporting company at least once every three years and reviews a significant number of companies more frequently. In addition, the Division selectively reviews transactional filings, i.e., the documents companies file when they engage in public offerings, business combination transactions, and proxy solicitations. Integrating additional technology into our review processes has improved investor access to public company filings, as well as increasing staff access to that information. Looking forward, it is imperative that we take advantage of the tools available to analyze the data filed with us.

<u>Questions 2 and 3</u>
What led to failures at the SEC and other regulatory agencies to discern the increasing risk to financial institutions under their jurisdiction?

What led to failures at financial institutions to recognize the inadequacy of their own risk management systems and strategy in time to avert a collapse?

In my view, there were numerous interconnected and mutually reinforcing causes that contributed to the failure of a number of major financial institutions, including:

- Irresponsible lending practices, facilitated by a securitization process that originally was viewed as a risk reduction mechanism;

- Perverse incentives and asymmetric compensation arrangements that encouraged excessive risk-taking;

- Insufficient risk management and risk oversight by companies involved in marketing and purchasing complex financial products;

- Excessive reliance on credit ratings by investors;

- A wide-spread view that markets were almost always self-correcting and an inadequate appreciation of the risks of deregulation that, in some areas, resulted in weaker standards and regulatory gaps;

- The proliferation of complex financial products, including derivatives, with illiquidity and other risk characteristics that were not fully transparent or understood; and

- The lack of an adequate statutory framework for the oversight of large investment bank holding companies on a consolidated basis.

With respect to the latter point, in 2004 the SEC established the Consolidated Supervised Entity (CSE) program in part as an effort to fill this gap in the U.S. regulatory structure left when the Gramm-Leach-Bliley Act failed to require investment bank holding companies to be regulated at the holding company level. Under the CSE program, the SEC was recognized as the consolidated supervisor for five of the largest independent investment banks. Notwithstanding the hard work of its staff, in hindsight it is clear that the program lacked sufficient resources and staffing, was under-managed, and at least in certain respects lacked a clear vision as to its scope and mandate. The CSE program was discontinued in September 2008 by former Chairman Christopher Cox.

In addition, another factor that contributed to agencies' inability to discern the increasing risks of certain financial institutions under their jurisdiction was the siloed financial regulatory framework that lacked the ability to monitor and reduce risks flowing across regulated entities and markets.

<u>Question 4</u>
How did so many investors get lulled into complacency and not adequately do their own due diligence?

Reliable information is an investor's best tool for wise investing. Far too often, there is a lack of reliable, readily available, current information. This lack of readily accessible information was a contributing factor to an overreliance on credit ratings. As was demonstrated by the recent financial crisis, this reliance was often misplaced. Ensuring access to information that is vital to investors is the best way to support investors in performing their own due diligence.