

**THE FISCAL YEAR 2012 BUDGET FOR THE  
SECURITIES AND EXCHANGE COMMISSION**

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**HEARING**  
BEFORE THE  
SUBCOMMITTEE ON  
SECURITIES, INSURANCE, AND INVESTMENT  
OF THE  
COMMITTEE ON  
BANKING, HOUSING, AND URBAN AFFAIRS  
UNITED STATES SENATE  
ONE HUNDRED TWELFTH CONGRESS  
FIRST SESSION  
ON  
EXAMINING THE FISCAL YEAR 2012 BUDGET FOR THE SECURITIES AND  
EXCHANGE COMMISSION

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MARCH 10, 2011  
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# C O N T E N T S

THURSDAY, MARCH 10, 2011

|  | Page |
|--|------|
| Opening statement of Chairman Reed .....   | 1    |
| Opening statements, comments, or prepared statements of:                               |      |
| Senator Crapo .....  | 3    |
| Prepared statement .....   | 24   |
| Senator Menendez .....   | 5    |
| Senator Warner .....   | 6    |
| <b>WITNESS</b>   |      |
| Mary L. Schapiro, Chairman, Securities and Exchange Commission .....                   | 6    |
| Prepared statement .....   | 24   |
| Responses to written questions of:   |      |
| Chairman Reed .....  | 34   |
| Senator Schumer .....  | 36   |
| Senator Crapo .....  | 38   |
| <b>ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD</b>                                     |      |
| Letter submitted by North American Securities Administrators Association,<br>Inc. .... | 42   |



# THE FISCAL YEAR 2012 BUDGET FOR THE SECURITIES AND EXCHANGE COMMISSION

THURSDAY, MARCH 10, 2011

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

The Committee met at 9:32 a.m., in room SD-538, Dirksen Senate Office Building, Hon. Jack Reed, Chairman of the Subcommittee, presiding.

## OPENING STATEMENT OF CHAIRMAN JACK REED

Chairman REED. Let me call the hearing to order. I want to first thank Chairwoman Schapiro for joining us today, but also, I want to say how much I look forward to working with Senator Crapo. We have had the privilege, from my standpoint, of working together now for many years on the Committee and I look forward to working with you as the Ranking Member of this Subcommittee.

But Chairman Schapiro, welcome. You are here today to testify on the fiscal year 2012 budget for the Securities and Exchange Commission.

This morning, we are looking at the funding needs of the SEC. We will address the question of funding to determine whether the agency has the necessary resources to effectively supervise and protect our capital markets. These markets are central to our financial system and promote capital formation and appropriate capital allocation, drive innovation, create jobs, and promote economic growth.

The SEC is literally the cop that patrols and safeguards our markets, and no one would consider withholding resources to our Nation's police and stripping them of the personnel and equipment they need to keep our homes and communities safe, but in some respects, that has happened to the SEC in the past. We have to make sure you use the resources wisely, but you have to have adequate resources to carry out these important tasks.

For example, between 2005 and 2007, just as the markets were reaching a critical stage, the SEC's budget was frozen or cut. As a result of these budget constraints, the SEC lost 10 percent of its staff, which severely hampered its enforcement and its examination programs, effectively taking these cops off the street just when they were most needed. Even now, frozen at the 2010 funding levels, the number of SEC staff has just only returned to where it was prior to 2005.

Similarly, the SEC's investment in needed technology has been significantly circumscribed due to funding constraints, and in this

world, I think the point was made in the Chairman's testimony, some of the companies that you regulate invest more money annually in information technology than your entire budget, and it is like trying to catch a fast sports car with my 1991 Ford Escort. It will not happen unless you get a little upgrade.

These manpower and technology constraints are occurring even though the workload of the SEC has increased considerably. A significant portion of the increased workload is due to the recent financial crisis and the important responsibilities placed on the SEC under the Dodd-Frank Act.

At the same time, the SEC is overseeing an increasingly vast and complex market. For example, from 2005 to 2007, during the same time that SEC resources were being slashed, the trading activities of the equities, options, and securities firms markets increased by \$3.5 trillion, a remarkable 91 percent increase in the activity of the institutions you supervise.

Over the past several years, the markets have become increasingly globalized and technologically driven. The result is that the markets are now larger, more complex, more volatile, and more intertwined. Without adequate resources, the SEC will be unable to respond to these market changes, and I fear will be only setting the stage for the next market crisis or crash.

I think one of the lessons I drew is that if we do not properly regulate the markets, then it should come as no surprise when they overshoot, when natural energies, as some have described, take over rationality and we have economic disasters, and unfortunately, we all end up paying for it.

On the other side, there are some who suggest that we cannot afford to fund the SEC in this time of fiscal belt-tightening. Well, I do not think this argument is accurate on the face. First of all, the SEC does not cost the taxpayer a dime. Ever since Congress amended the securities laws in 1996, 100 percent of the SEC's funding comes from Wall Street registration and filing fees. As a result, no matter the funding level, the SEC budget has no effect on the Federal deficit or budget.

And as for the fees assessed against Wall Street, when considering the huge transaction volumes, these fees are practically negligible. The vast majority of SEC funding is derived from Section 31 securities transaction fees, which are currently levied at \$19.20 per million dollars in transaction. That works out roughly to two cents per \$1,000 of transactions—two cents per \$1,000 of transactions. And this, indeed, is a very small price for an industry that relies so much on the confidence of investors that you are doing our job, that you are forcing them to be fully disclosing their information that is relevant to investment decisions.

Now, others have suggested that defunding the SEC is really just a means to repeal Dodd-Frank. I think that would be a very, very misguided approach. If there are issues with respect to the legislation, they should be addressed legislatively, explicitly, up front. I have not participated in a legislative activity that cannot be improved by thoughtful, careful consideration. But simply to deny funding to the agencies involved in implementation is wrong, and I think drastically and dreadfully wrong, because it will result, as

I have just suggested, in market disruptions that we will all pay for much, much more.

The Dodd-Frank Act has gone a long way to addressing, I think, some of the issues that caused the financial crisis. These reforms, once implemented, will make our capital markets fairer, safer, and less prone to systemic collapse. It will bring investors and insurers back into the market to benefit the entire economy.

For this to happen, though, and I repeat again and again, the SEC needs the resources to do their job effectively, and I am afraid if the SEC is denied these resources, if there is no cop on the beat with the funding it needs to oversee these markets, we will not only endanger economic growth, but we could, indeed, sow the seeds for the next financial crisis, which we cannot afford and we do not want to impose upon the country again.

But thank you very much, and again, let me recognize the Ranking Member, Senator Crapo, for his opening remarks, and once again say what a privilege it is to serve with you.

#### **STATEMENT OF SENATOR MIKE CRAPO**

Senator CRAPO. Thank you very much, Mr. Chairman, and I agree and want to reflect the same feelings in terms of my appreciation of working with you over the years. I look forward to our service together on this Subcommittee on some of the issues that are some of the most critical to our Nation as we seek to revive and strengthen our economy. So again, I look forward to that and appreciate your comments.

Chairman Schapiro and Mr. Chairman, as I look at the SEC budget, I find myself of two minds because, on the one side, I completely agree with the comments that the Chairman made about how important the functions of the SEC are, and, frankly, I recognize that there has been underfunding in the past that has not allowed the SEC to aggressively and effectively do its job and have been one of those who has been willing to see the budget of the SEC supplemented in such a way that it can get the task done.

On the other hand, I am one of those who would like to see Dodd-Frank slowed down, and, frankly, think that we made a mistake when we passed the Dodd-Frank legislation. And although the budget of the SEC comes from fees, not from taxpayer dollars, I also view the current debt crisis that we are in as one that requires that across all levels of Government, whether it is the income tax or whether it is a fee on transactions, that we pay very careful attention that we not just drive up the cost of Government to the taxpayer or to the consumer without paying very, very close attention to the need to become much more efficient and much more effective with taxpayer and consumer dollars. So I see both sides of this equation.

It was recently announced that we are yet facing another record Federal deficit at \$1.6 trillion, and the budget that we recently received from the President would result in doubling the national debt to more than \$26 trillion by the end of the decade. As a member of the President's Fiscal Commission on Responsibility and Reform who voted to support the report that would confront our ever-increasing national deficit and the unrestrained spending, I believe

all agencies and programs should be prepared to engage in this process and that all budgets have to be evaluated.

The Dodd-Frank Act gave the SEC many new oversight responsibilities, including writing new rules that would ensure—and ensuring that they are reformed and regulating new entities. The SEC will need to devote staff to these responsibilities, particularly once the rules take effect. The new demand for resources presents an opportunity, in my mind, to undertake an agency-wide examination of how existing resources are being expended and whether any of them can be better utilized.

Some of the questions that need to be answered in my mind are, what factors went into determining how many people would be needed for each Dodd-Frank area of responsibility and at what time period would they be needed? Are there ways to use technology both to make existing staff more productive and to reduce the number of employees needed for Dodd-Frank responsibilities? Has the SEC worked with the CFTC to share information technology development costs for the oversight of the OTC derivatives market?

While the Dodd-Frank Act, in my opinion, missed a great opportunity to merge the SEC and the CFTC and stop the bifurcation of the futures and securities markets, there is no reason why we should not push for more coordination, more consistent rules, and, frankly, budgetary savings. A recent report by GAO shows duplication among the efforts of a number of Federal programs which may cost our Government more than \$100 billion in overlapping efforts.

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

In a short time period, the Dodd-Frank Act requires the SEC to promulgate more than 100 new rules, to create five new offices, and to conduct more than 20 studies and reports. The volumes of this rulemaking and the unrealistic Congressional time line that was imposed, I think, poses a significant challenge to the SEC.

Madam Chairman, as you know from our conversations and communications, I think that there is a very potential likely impact of the Dodd-Frank Act that will be not only enormous, but will generate costs of of which we have no idea yet in terms of their ultimate scope. Given our prior experience, such as the original estimates about the cost of Sarbanes-Oxley in 2002, these actual costs are going to prove substantially more significant than either legislators or regulators contemplated.

It is more important than ever that the SEC allow for meaningful public comment and economic analysis than it is to rush through these rules and risk undermining the integrity of the process. And regardless of the ultimate outcome of the budget issues, I, again, encourage you to make sure that we undertake the careful, thoughtful evaluation of the rules that are now authorized and required under Dodd-Frank and do so in a way that does evaluate the economic impact as well as the other policy-oriented impacts that are at risk. The potential harm to our already weak economy



and the public from ill-conceived rules, in my opinion, cannot be understated.

So with that, Mr. Chairman, I appreciate the opportunity to make these comments and look forward to the testimony.

Chairman REED. Thank you very much, Senator Crapo.

Senator Menendez, do you have some opening comments?

#### **STATEMENT OF SENATOR ROBERT MENENDEZ**

Senator MENENDEZ. Thank you, Mr. Chairman, just a few brief ones. Madam Chair, thanks for joining us.

Mr. Chairman, what I want to ensure is that we do not relive what this country went through in 2008, and in part, that is because we did not have the type of robust regulatory regime and enforcement that is necessary to ensure that while we have a free market—and I am all for a free market, but there is a difference between a free market and a free-for-all market. Many of us believe that we had a free-for-all market, and part of that was the lack of robust regulatory oversight and having a cop at the beat instead of asleep at the switch.

And so I am seriously concerned, and I want to thank you, Mr. Chairman, as well as Senator Johnson, the Chairman of the full Committee, and 13 other colleagues who have signed a letter that we are sending to Senate appropriators requesting that they fund the Securities and Exchange Commission and the CFTC at the higher levels requested in the President's budget for fiscal year 2012.

I listen to families back in New Jersey all the time who always question, well, why is it that this happened, and when I make a mistake, I have to pay for my mistake, and when they make a mistake, I have to pay for their mistakes. And I understand that type of thinking. There are a lot of middle-class families back in New Jersey who lost a good part or all of their life savings because of swindlers on Wall Street.

So we need to have a strong cop on the beat to police Wall Street and I believe it would be a grave mistake to reduce funding for the SEC—and I know this is not the subject of today's hearing, but for that fact, the CFTC—as, for example, House Republicans do under H.R. 1. It is the worst possible time to do that, just as these agencies are being asked to undertake the Herculean task of implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act, and that is a task that I believe is absolutely critical to protecting middle-class investors. Our regulators have to be given the resources to get it done and then we can hold them accountable.

This proposal also comes after a prolonged period in which the markets they are expected to regulate have exploded while their funding has remained about the same.

You know, just by way of examples, and this is only examples, Goldman Sachs generated \$8.3 billion in profit in 2010 alone, five times more than the size of President Obama's funding request. In 2005, the SEC had provided 19 examiners for a trillion dollars in investment under management. Today, that figure stands at 12 examiners per trillion dollars. And in 2010, the SEC returned \$2.2 billion to harmed investors, twice the agency's budget.

So I do not think, especially when this funding, in essence, comes from fees collected from the industry, that it makes a lot of sense to undermine the entity that we want to see as the cop on the beat.

I look forward to today's hearings and I want to thank you, Mr. Chairman, for your leadership in this regard.

Chairman REED. Senator Warner, do you have comments?

#### **STATEMENT OF SENATOR MARK R. WARNER**

Senator WARNER. I will just make a brief comment. First of all, Mr. Chairman, thank you for holding this hearing and I think it is great to see Chairman Schapiro.

I just want to, somewhere between both of my colleagues' comments—this is for myself—I concur with the Ranking Member and commend his leadership on the Deficit Commission and everything has to be on the table and how can we become more effective at every dollar we spend, although I would, as Senator Menendez has pointed out, the fees, since they are paid by people who receive the SEC services, this does not affect the deficit in any way.

But I think as any good investor or business person knows, and somebody who spent a career in business before getting in this job, even during tight times, you have got to make targeted investments, and the amount of money that is involved in the financial system, in trying to regulate that and trying to at least not so much regulate, I would say, but as to make sure—and this is where my questioning will go when I get my time—make sure that investors have confidence in our systems and the markets, confidence that I would argue was robbed in 2008 and then re-robbd again with the flash crash in 2010. And I think there is an extraordinarily important public purpose that the SEC serves about that question of confidence in the markets that, in a sense, trumps even some of the regulatory responsibilities, and I want to press you when my time is on on how we make sure that you do a good job of that.

But thank you, Mr. Chairman, for this hearing.

Chairman REED. Thank you very much, Senator Warner.

Now it is my privilege to introduce the Chairman of the Securities and Exchange Commission, the Honorable Mary Schapiro. Prior to becoming SEC Chairman, she was the CEO of the Financial Industry Regulatory Authority, FINRA, the largest nongovernmental regulator for all securities firms doing business with the United States public. Chairman Schapiro previously served as the Commissioner of the SEC from December 1988 to October 1994, and then as Chairman of the Commodities Futures Trading Commission from 1994 until 1996.

Welcome, Chairman Schapiro.

#### **STATEMENT OF MARY L. SCHAPIRO, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION**

Ms. SCHAPIRO. Thank you. Chairman Reed, Ranking Member Crapo, Senator Warner, Senator Menendez, thank you for the opportunity to testify in support of the President's fiscal year 2012 budget request for the United States Securities and Exchange Commission.

The \$1.4 billion that the President is requesting is designed to help us adequately staff the agency so we can fulfill our core mission of protecting investors, expand our information technology system so we can realize operational efficiencies and better keep pace with increasingly sophisticated financial market participants, and carry out our new responsibilities over hedge funds, derivatives, and credit rating agencies.

As you know, over the past 2 years, we have worked tirelessly to make the SEC a more vigilant, agile, and responsive agency, and we are moving forward on multiple fronts to enhance its effectiveness and provide robust oversight of the financial markets. In addition, we have embarked on a vigorous rulemaking agenda, addressing critical issues, including equity market structure, money market fund resiliency, asset-backed securities, consolidated audit trail, and municipal securities disclosure.

I believe we have made a number of necessary changes and accomplished a great deal. But this year, we find ourselves at a critical juncture. This is because Congress has challenged us not only to continue our reform efforts and carry out our core responsibilities, but also to fulfill the significant new responsibilities under the Dodd-Frank Act.

As you know, separate and apart from that legislation, the SEC is responsible for essential activities, such as pursuing securities fraud, reviewing public company disclosures, inspecting the activities of investment advisors and broker-dealers, and ensuring fair and efficient markets. And because of the new legislation, we are taking on considerable new responsibilities for oversight of the over-the-counter derivatives market and hedge fund advisors, registration of municipal advisors and security-based swap market participants, enhanced supervision of credit rating agencies, heightened regulation of asset-backed securities, and the creation of a new whistleblower program.

In recent years, the SEC faced significant challenges in maintaining staffing levels sufficient to carry out its existing mission. For instance, from 2005 to 2007, the SEC experienced 3 years of flat or reduced budgets, forcing a 10-percent reduction of our staff. Similarly, the agency's investment in new or enhanced IT systems declined approximately 50 percent from 2005 to 2009. And at the same time, the size and complexity of the securities markets were growing at a rapid pace. Indeed, during the past decade, trading volume more than doubled, the number of investment advisors grew by 50 percent, and the assets they manage increased to \$38 trillion.

Today, the SEC has responsibility for approximately 35,000 entities, including direct oversight of more than 11,000 investment advisors, 7,000 mutual funds where the vast majority of Americans hold their securities investments, and 5,000 broker-dealers with more than 160,000 branch offices. We also review the disclosures and financial statements of approximately 10,000 reporting companies, and we oversee transfer agents, national securities exchanges, clearing agencies, and credit rating agencies. Indeed, we oversee some financial firms that, as was pointed out, regularly spend many times more just on their technology operations than the SEC's entire budget.

A budget of \$1.4 billion will allow us to hire the experts and acquire the technology we need if we are to effectively carry out our core responsibilities and begin to implement the Dodd-Frank Act. Of the 2012 requested amount, we estimate that \$123 million will be allocated to begin implementing the provisions of the new law this year.

And it will support information technology investments of \$78 million. This level of funding would support vital new technology initiatives from data management and integration to internal accounting and financial reporting.

The funding also will permit the agency to develop risk analysis tools to help us triage and analyze tips, complaints, and referrals, and it will permit us to complete a digital forensic lab that enforcement staff can use to recreate data from computer hard drives and cell phones to capture evidence of sophisticated frauds.

Finally, it is important to note that the SEC's fiscal year 2012 funding request would be fully offset by matching collections of fees on securities transactions. Beginning with fiscal year 2012, the SEC is required to adjust its fee rates so that the amount collected will match the total amount appropriated for the agency by Congress. Under this mechanism, the SEC will be deficit neutral.

I thank the Committee for your support and I look forward to working with you to improve the agency's performance of its core mission, to implement our new responsibilities, and to continue protecting investors, and I am happy to answer your questions. Thank you.

Chairman REED. Thank you very much, Chairman, for your not only testimony today, but for your leadership.

Just as an initial point, once again, and sort of taking up a point that Senator Crapo made about the CFTC and the SEC, there was a brief moment there where that merger was considered, but for many reasons, that is not the law. But still, the need to cooperate, and I commend you because you and Chairman Gensler are doing a remarkable job of trying to issue joint rulemakings in very critical areas. But as we talk about, and I feel as if I am sort of arguing out of my lane here because it is the Agriculture Committee, *et cetera*, but as we talk about the SEC budget, the CFTC budget is equally constrained, and so I will just, in a spirit of camaraderie, put in a plug, also, that a lot of what we say here applies to CFTC.

One point I want to begin is to just ask you to reflect upon the huge increase in demands because of the changing marketplace. As you pointed out in your testimony, not too long ago, the New York Stock Exchange was performing the majority of trades. Now, it is about 20 percent of trading volume, I think, and that is a rough estimate. You have got dark pools, three different electronic networks, you have a host of other ways to trade securities today. And then you have high-frequency trading, and Senator Warner alluded to it, the near collapse of the markets recently because of high-frequency trading activity.

Can you just talk about these challenges? And again, these are challenges—putting Dodd-Frank aside, these are challenges just of an absolutely remarkable and dynamic marketplace.

And just a final point is, we were all sitting here, as I look around, last year considering Dodd-Frank. I do not think any of us

had in the forefront of our mind the idea that the New York Stock Exchange and the German Deutsche Borse would be combining. So this is a really different world. Can you comment on how you are reacting to it, Madam Chairman?

Ms. SCHAPIRO. Sure. I would be very happy to. And I think May 6 and the extraordinary volatility we saw that day is actually a good lens through which to view the evolution in our markets and the changes, because it brought together in a very painful way but a very crisp and concise way what has really happened with the U.S. equity markets over the last decade.

As you point out, we have so many trading venues—more than 50 trading venues, and if you add in the number of broker-dealers, which exceeds 200, which actually internalize orders and they never see the public tape pretrade, we have a highly fragmented and highly complex equity market structure today in the United States.

And what we saw on May 6 that created particular challenges for the Securities and Exchange Commission and, to a lesser extent, for the CFTC, because they have a much more monolithic market structure, is that the need to surveil these markets has not diminished. In fact, it has increased as a result of the fragmentation. Yet our capacity to do so is greatly diminished because every market has its own audit trail, and we needed to bring in massive amounts of data and try to collate it and coordinate it. And it was massive amounts of data because high-frequency traders enter thousands and thousands of orders in a second, canceling many of those but creating very fundamentally, the amount of data that has to be analyzed to understand what happened. What went wrong in the market that day.

Our capability to do that was really severely limited by our lack of technology, and to a lesser extent by our lack of enough people with expertise in understanding how algorithms work, how algorithms can go wrong in the marketplace, how all these different market structures are connected or disconnected, and how the equity markets and the futures markets and the options markets all interact together.

Our budget really recognizes the shortcomings that we felt existed after May 6. We were able, and we testified several times before this Committee, we were able to reconstruct the trading. It took about 5 months. It took heroic efforts on the part of our staff. We put together an advisory Committee, including two Nobel laureates, to help advise us. We have a game plan going forward. We accomplished a lot with single stock circuit breakers and new rules for the exchanges to deal with the immediate after effects of May 6.

But it argues for a much deeper, much more thoughtful review of all of these aspects of our markets so that we can ensure that they are not fragile, that they are not subject to unnatural volatility, and so that investors can continue to have confidence in them.

One of the most acute lessons for me from May 6, and I still ask every broker-dealer I meet with, how did your customers fare on May 6? What was their reaction to participating in our markets after May 6? And there has been a lasting impact. People under-

stand they lose money when they buy or sell a stock because the value of the company goes up or down, but they do not understand when the market does not work, and we have to be there and ensure that the market is working.

Chairman REED. Thank you very much.

Let me ask a final question and then I will recognize the Ranking Member, and we will do two rounds. I think we can do several rounds if your time allows, but I want to give my colleagues a chance to ask questions, also. I have several more.

You have made the point that these increases in your budget would be fully offset by adjusted fees for the financial industry, so there would be no deficit impact. My sense is, my hope is, that your colleagues, our colleagues, if you will, on Wall Street understand that the value of an effective SEC adds value to their operations. If you want to look at the first casualties of the financial crisis, it was the thousands of people that were laid off of firms. It was historic firms that collapsed. It was a market that was in shock for months. Not all of that can be laid at the feet of inadequate funding, but part of it can.

And the question I have is, are you sensing sort of opposition from the industry to an adequately funded SEC? It might be a popular political stance, but do they not get it, that if you are—they might enjoy two or 3 weeks of sort of a wild weekend, but somebody has got to clean up the debris and usually they are the first casualties?

Ms. SCHAPIRO. Well, I think it is safe to say that the industry does not love everything we do—

Chairman REED. Right.

Ms. SCHAPIRO. —and I understand that, and we would not be doing our job if they did.

Chairman REED. If they did, we would be wondering—

Ms. SCHAPIRO. You would be wondering what we were doing.

Chairman REED. Right.

Ms. SCHAPIRO. But I do think that the industry, by and large, believes having a strong regulator provides them credibility and provides confidence to investors, and if investors are not confident, they will not be in these markets. We saw that after May 6. We have seen it in other periods in history. I think that the responsible members of the industry absolutely believe that a strong, effective SEC is in their absolute best interest, and a knowledgeable SEC. The burden on them is less when we know what we are doing. When we can interact with them using technology, maybe, instead of people all the time. When our examiners come in and they understand the right questions to ask and what they are looking for. That actually lessens the burden on the industry, as well.

So I am highly confident that responsible members of the industry, and I think that is most of the industry, believe that having a strong regulator is absolutely a positive.

Chairman REED. Thank you very much, Madam Chairman.

Senator CRAPO.

Senator CRAPO. Thank you very much, Mr. Chairman, and again, Chairman Schapiro, thank you for the work you do and for being here with us today to evaluate these budget issues.

As I said in my introductory remarks, I am of both minds on this. I understand the need that the agency has, and, in fact, I see the benefit of making sure that the agency has the resources to do its job and to do its job effectively, efficiently, and well. Perhaps my concern focuses more on the process itself in terms of how these agency funds will be utilized.

To return to the issue relating to the implementation of Dodd-Frank, not in an effort to try to relitigate Dodd-Frank, although I would love the opportunity to get engaged again on that if we would have that opportunity, we now, as I indicated, have a set of over 100 rulemakings that the agency is tasked with, the creation of new entities, and so forth.

And on February 15, the Republican Members of the Banking Committee sent you and the other financial regulators a letter basically explaining concerns that we have at this time with the speed at which the rulemaking, the phenomenal amount of rulemaking that Dodd-Frank contemplates, is being implemented, and concern that that speed is causing us to lose effectiveness and, frankly, in some cases, to cause very significant unintended consequences. The letter indicates that, as we have seen it, the public comment periods are a little over 40 days, which is substantially less—on the average—which is substantially less than the 60-day public minimum period that is generally required by OMB, and that some of those rules that have already been made in such a rushed fashion have, upon further evaluation, been found to have very significant unintended consequences. And I will not go into some of the details. Some of the Commissioners of both the CFTC and the SEC have commented about this problem and suggested that we need a way to have more rigorous analysis.

My question to you is, what do you feel about the request of our letter that asked that we have at least a 60-day public comment period for the rules as they are being implemented?

Ms. SCHAPIRO. Senator, I think we did not start out, as a general rule, on most rules with 60-day comment periods because the statutory deadlines were very tight. I will say, though, that I think, effectively, that is largely where we have ended up. We have done precomment periods before proposals went out to gather views from the industry. Of course, we have had hundreds of meetings with industry and market participants. We always accept comment letters, even after the comment period is closed, right up until the day before, practically, the Commission will make a decision.

So, effectively, the periods have been longer, and, of course, for a major set of rules, we just reopened the comment period. This relates to the conflicts of interest that may exist in the governance and ownership structure of clearing agencies, swap execution facilities, and exchanges. And because we did subsequent rulemaking that implicated what we called our Reg MC proposed last October, we reopened that just a week or so ago to say, please think about conflicts of interest, governance, in light of these other things we have done: open and fair access to the markets, the opportunity for the SEC to review rules, governance requirements, the presence of risk committees, and so forth. So we have tried to be very sensitive to that.

I recognize there has been a burden on the industry to try to get thoughtful comments in, but I can also say that I think we have gotten extraordinarily high-quality comments on every rule we have put out and we will continue to be as flexible as we possibly can.

All of that said, we are going to miss some deadlines, without a doubt, and part of that will be because we are taking the time we think we really need to try to get these right. We are not rushing to judgment.

Senator CRAPO. Thank you, and I appreciate your thoughtful response to this difficult issue. You have indicated that the statutory deadlines that you face are causing some of the pressure that is there, and I guess my question would be, do you think it would be helpful if Congress were to provide a little bit of relief by extending the deadlines or removing this rush to rulemaking that is included in the Act?

Ms. SCHAPIRO. Well, I think there is another way for us to deal with it if Congress chose not to reopen the deadlines and that would be through our phased implementation of any of the requirements, so that even if we have rules, even if we were to have all the derivatives rules in place on July 21—and we will not—we are going to seek broad industry input on how to sequence the implementation of those rules from their perspective because they are going to have to build some technologies, linkages, data repositories. There is lots of work to do before these rules actually become effective. So we want to sequence them appropriately for implementation and give enough time so that this is done well and done right. And so I think that gives us a fair cushion of time, I think, before we would have unintended consequences arise.

Senator CRAPO. Well, thank you. I see my time is up and I will just make my last comment on this round, and maybe this comment is to my colleagues more than to the Chairman.

It seems to me that we are causing the agencies to rush and then try to create these processes of phased implementation that I think maybe can make sort of a—cause ripples and impacts in the economy that are unnecessary, and that perhaps we ought to consider looking at whether the time lines in the Act were realistic in terms of this rulemaking. But I will leave that for discussion among ourselves, and thank you, Mr. Chairman.

Chairman REED. Thank you very much, Senator Crapo.

Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

Madam Chair, if you ended up receiving what in essence is the House budget proposition for the Securities and Exchange Commission, what would be the practical effect of that? How would the agency's mission, if at all, be compromised? What would you have to forego in terms of both your enforcement examination and overseeing corporate disclosure responsibilities?

Ms. SCHAPIRO. Senator, the proposal to take such a dramatic cut, I believe to go back to 2008 levels—is that the right—

Mr. SPITLER. Forty-one million.

Ms. SCHAPIRO. —a \$41 million reduction would have a very significant impact on the SEC. We have not determined, although we are doing all of the background work to be prepared, how many



people versus how much technology would be impacted by that. But we would certainly be in a position of laying off a significant number of employees and we would be in a position of halting, really, any technology development, including anything related to the market structure issues we are so concerned about. We would not be able to operationalize the Dodd-Frank rules that are in place, whether it is on the corporate disclosure side or the derivatives or hedge fund registration, municipal advisors. All of those areas would be profoundly impacted.

And we would have to make some extremely difficult choices, and not just difficult for us, but I think difficult for the American people, because they need to believe and understand that there is a watchdog who is watching out for their interests, and our ability to examine mutual funds where American investors have their resources, or broker-dealers who are interacting through 160,000 branch offices around the country with retail investors, or investment advisors of which we are responsible for 11,000, our ability to oversee them in anything but the most cursory way would be, I think, deeply impacted.

Senator MENENDEZ. So would it be fair to say, then, that if you had to live with H.R. 1's budget, that, in fact, investors would be less protected, that there would be potentially less integrity in the market, because you would not be able to police it, and you would not really be the vigorous cop on the beat that I think many of us want you to be?

Ms. SCHAPIRO. I think that is fair to say, and we would be less efficient, because one of my goals since I arrived 2 years ago was to try to utilize technology more efficiently so that we can free up human resources for higher-value work and have technology take care of many more routine things than it does right now at the agency. So I think all three of those things.

Senator MENENDEZ. You have often, not only at this hearing but in the past, talked about—I have often talked about examiners and those human capital. You have often referred to technology. So give us an insight as to what you are dealing with in terms of your needs and what your challenge is compared to the technology that the industry has. I often think that the street is way beyond the SEC in the context of its ability to move forward, to have complex financial instruments, and that very often the SEC is in a position of catching up. So maybe that is the wrong perception, maybe it is right. Why do you not tell me what your challenges in this are.

Ms. SCHAPIRO. I do not think it is a wrong perception. I think that there are large firms that, between telecom and computer operations, spend \$2 or \$3 billion a year, whereas we spent a billion dollars on our entire budget altogether.

The interesting thing to me, and almost the sad thing here, is that right now, we are able to recruit enormous talent. We have changed the entire senior leadership of the SEC in the last 2 years and we have brought in people who are really quite extraordinary and quite expert. We can get people from hedge funds to come to the SEC, from trading desks, financial analysts, credit rating agencies, exactly the kind of talent we need right now. There is a desire to come and work at the SEC.

But because of hiring restrictions, even just operating under the CR, we cannot bring those people on board. I am confident if we could also not only bring them on board but offer them a modest amount of money to spend on technology to make their jobs easier and to make them more effective, to give them the tools to analyze data, to give them the tools to take the more risk-based approach we hope to take to everything we do, that there would be genuine enthusiasm for joining our ranks and serving the public in that way.

Senator MENENDEZ. So let me ask you this final question. As someone who is an advocate for the robust budget that I think that you need to do the job that we want you to do on behalf of American investors, and ultimately about everyone in this economy so we do not relive some of the challenges of the past, are you, in the context of your present budget and resources, operating in the most efficient and effective manner possible?

Ms. SCHAPIRO. There is no doubt that while we have worked hard to try to drive inefficiencies out, there is more to do. I am confident of that. And we actually have a new Chief Operating Officer for the first time in the SEC's history who joined us last year and he is leading what we call a Tiger Team, looking for ways to cut excess costs out of the budget so that we can redeploy that money to higher and better uses. So we are not, by the longest shot, perfect. We have a lot of work to do, but we are very focused on getting the most for every dollar that we have.

Senator MENENDEZ. Thank you, Mr. Chairman. Thank you.

Chairman REED. Thank you very much, Senator Menendez.

Chairman Schapiro, the Inspector General has done a series of reviews and made recommendations, I think about 69 specific recommendations, regarding the Division of Enforcement, the Office of Compliance Inspections and Examinations. Can you indicate how you have been able to utilize his advice to make improvements within the operations and any other comments you might have?

Ms. SCHAPIRO. Yes. I am happy to do that, because I value the advice and recommendations that we get from the Inspector General as well as from the Government Accountability Office.

I can say that in the last 2 years, in the time that I became Chairman, we have successfully closed out 350 Inspector General recommendations and implemented them, compared with about 190 for the 2 years prior to my becoming Chairman. So we hold senior managers accountable for fulfilling the obligations that they have under IG recommendations. We actually require within 45 days of an Inspector General report that the staff develop a corrective action plan to fulfill those recommendations, review that with the Inspector General, and get those recommendations closed out. And then we have a senior manager who is responsible for making sure all of that happens. So we value his recommendations, and a high percentage of the time, we agree with them and fully implement them.

Chairman REED. Well, thank you very much. In fact, I would note that Inspector General Kotz, in his testimony February 10, 2011, before the House, indicated that he was pleased to report that the overwhelming majority of our recommendations have been implemented, and accordingly, we are confident that the situation

we identified had been ameliorated and will not reoccur. So that is—IGs play valuable roles, and when they are satisfied, that is a good sign—

Ms. SCHAPIRO. Mr. Chairman, could I correct one thing I said—

Chairman REED. Yes, ma'am.

Ms. SCHAPIRO. —in response to Senator Menendez. At a \$41 million cut, we are looking at furloughs of staff—I do not know for how long a period—rather than layoffs.

Chairman REED. Thank you.

Ms. SCHAPIRO. I just wanted that to be clear. Thank you.

Chairman REED. That is an important point.

There is another aspect to your testimony, too, is that as you alluded to, the GAO has made comments about the, basically the administration of the Commission, *et cetera*, and you have now taken steps to move some of your functions under the supervision of, and correct me if I am wrong, an agency in the Department of Transportation who has great expertise. Can you—this, to me, is not only indicative of trying to improve the performance of your Department, but also trying to recognize the skill sets in other governmental departments and essentially maximize the taxpayers' investment in these skills, not simply going out, as is typical in the past, and signing a big contract with a big company to provide services, hopefully good services, but can you comment?

Ms. SCHAPIRO. I would be happy to. GAO found that the SEC had material weaknesses in our internal controls over financial reporting. They were basically—fall into two categories, gaps in our security and then functionality of our financial systems, frankly, as a result of years of under-investment and care paid there. Rather than spend a lot of money to try to remediate those systems and plug all the holes, our new Chief Financial Officer, our new Chief Information Officer, our new Chief Operating Officer and I determined that we would be much better off to outsource to a Federal shared service provider who could provide those services to us and we would not have to bring in people to do that on the SEC's payroll, because as you point out, it is not really a core competency for us to run those kinds of systems.

So we selected the Department of Transportation. We have signed the agreement with them. And the cutover is expected to happen in April of next year. We are working very closely with them on a daily basis to make sure that we are in a position for that to happen. But I really believe outsourcing this function from the agency is the right decision for taxpayers and it is the right decision for the SEC. It allows us to focus on what we do best, and DOT actually provides this service for the General Accountability Office [*sic*], so I have a high level of comfort that they will do a good job for us.

Chairman REED. A final point before I turn it back over to Senator Crapo is that your comments also reveal something that I do not think is understood as much as it can be. For the first time in, if I am correct, in the history of the agency, you have a Chief Financial Officer?

Ms. SCHAPIRO. We have had a Chief Financial Officer before. We have never had a Chief Operating Officer.

Chairman REED. So—

Ms. SCHAPIRO. Although we have a new Chief Financial Officer and we have a first-class Chief Operating Officer.

Chairman REED. And in terms of Chief Information Officer, is that a relatively new position?

Ms. SCHAPIRO. No. We had one—we have had one historically. We have a brand new one who has done, I think, an extraordinary job in the very short time he has been on board.

Chairman REED. But with your Chief Operating Officer now, you are beginning to employ some of the techniques that have been routine in private industry?

Ms. SCHAPIRO. Exactly. We now have dashboards. We now understand where we have systems issues. We see where money is going with much more granularity. We have accountability and metrics that are allowing us to run the SEC much more like a business. We are not there yet, but with their leadership, I am highly confident we will be.

Chairman REED. Thank you very much.

Senator Crapo? And just for the record, Senator Hagan was here first and she will be recognized, then Senator Warner, just to keep everybody's schedules running.

Senator CRAPO. Thank you, Mr. Chairman.

Chairman Schapiro, I want to go back to the regulatory issue. As I am sure you are aware, on January 18, the President issued an Executive Order with regard to the goal of improving regulations and regulatory review and reducing the burden of regulations on our economy. It is my understanding, though, that that Executive Order does not apply to the SEC or the other financial regulators. Is that your understanding?

Ms. SCHAPIRO. That is correct. I guess as a matter of law, it does not apply to the SEC. But as a matter of practice, it is our view that we should subscribe to the goals that are set out in the Executive Order. So, for example, many things that are required by it, we already do—notice and comment rulemaking, cost-benefit analysis, burden on competitiveness analysis, and so forth. But also with respect to impacts on small business, trying to delay implementation and give small businesses easier ways to comply with regulations is something we are very focused on trying to do, as well as going back, when we can catch our breath, and look at the rules that are on our books right now that perhaps do not make sense anymore in that this day and age.

Senator CRAPO. Well, that is good, because you actually contemplated my next question, which was would it not be a good idea, even though it is not binding, for the agency to, or the Commission to pursue the objectives, one of which is to achieve the least burden on society consistent with the regulatory objective, which I think is a little different than just doing a cost-benefit analysis.

So maybe what I would like to ask you to do is my understanding is that you do do cost-benefit analysis. You also do an analysis, do you not, with regard to the impact on capital formation?

Ms. SCHAPIRO. Yes. The goal is for us to seek the least burden on competition in our approach to rulemaking.

Senator CRAPO. And how does that process work? It seems to me that that would be incredibly important to make sure, first of all, that a cost-benefit analysis is done, and that you seek the objective of having the least burdensome solution that you can find in terms of competition. But what happens in the cost-benefit analysis process in terms of how that plays out and if you determine that there are costs to competition or to capital formation or to the economy in general?

Ms. SCHAPIRO. Well, one of the real benefits of the cost-benefit analysis is it is performed by our economists and rule writers. We have about 30 economists on the staff and we are currently recruiting for a new Chief Economist. They prepare cost-benefit analysis based on the rule proposals. Those go out for comment, and from my perspective, that is much of the value, is what the rest of the world thinks about our economic analysis. Are our numbers crazy? Are the costs way off? Are there burdens that we did not anticipate when we did our analysis? And so we get that comment in, which is extremely helpful to us, and then factor that into any final rule-making decisions.

Senator CRAPO. And do you feel that, ultimately, the objective is consistent with the statutory mandate, achieving the least costly alternative?

Ms. SCHAPIRO. That is certainly the goal, and we also, I should say, routinely request economic data from commenters to help supplement our internal comment.

I will tell you, though, sometimes it is very hard to quantify what the benefit is of a particular rule, and that can be very difficult. But the goal is certainly to try to take the least costly, least burdensome approach. I will not tell you we always get there, but that is the goal.

Senator CRAPO. And to get back to my first question, do you think that the timeframe that we are operating under, which is—I understand the flexibility you described that you use to try to get beyond the 40 days average that we are seeing. Do you think the timeframe that we are seeing here gives the opportunity—the adequate opportunity for evaluation by those who are looking at these cost-benefit analyses and the capital formation analyses?

Ms. SCHAPIRO. You know, it is probably a better question for them. I am sure if there were more time that they would use more time and they would be grateful to have it in order to do more full analyses. But as I said, the quality of comments we are getting, I think, are quite high and have been very, very helpful to us, and I think as you see final rules come out—we have done very few final rules—you will see, I think, them very much influenced by the comments.

Senator CRAPO. And does the staged implementation process that you described allow for further input on the cost-benefit analysis and capital formation analysis?

Ms. SCHAPIRO. Not formally, but we would be happy to have that kind of information, and if during an implementation period we learn something new that suggests that a rule that we have proposed and finalized is going to have an unintended or severe consequence, we have the flexibility, I think, to say we are going to

not go ahead and implement until we understand better what the implications of that are.

Senator CRAPO. Thank you.

Chairman REED. Thank you.

Senator Hagan.

Senator HAGAN. Thank you, Mr. Chairman.

Chairwoman Schapiro, thank you for being here. I know you spent a lot of time testifying before Congress recently, and I know that in your last testimony before this Committee, you testified about the more than 100 rulemaking provisions and 20 studies and five new offices that the SEC is currently working on. And I know that these activities range from the swap execution facilities and the Volcker Rule to risk retention and fiduciary standards of conduct, and those are at the very core of the Dodd-Frank Act that we passed last year and are obviously crucial to restoring stability to our financial area.

I know you have got a difficult job and a very important job, so I thank you for your hard work. At this point, I think it is incumbent upon Congress to get you the resources that you need in order to do this important work in an effective and timely manner, and so I am pleased that you are here.

One question that is of particular interest to me is how the short-term continuing resolutions that we have been doing in Congress lately have impacted your ability to operate, your ability to invest in people, and importantly, your ability to invest in technology, and then how would a string of short-term continuing resolutions further impact your agency?

Ms. SCHAPIRO. Well, I think, to me, the biggest impact has been in our inability to hire more than very few selected positions, because as I was saying earlier, we have the opportunity to bring on board tremendous talent to the SEC right now. There are lots of people with deep industry experience and expertise that we need to do our jobs well who are willing and actually anxious to come to the agency and we are not able to make offers to those people. So I think that is one of the greatest consequences and, unfortunately, one that will have some lasting effect, because it takes time to bring people on board, get them up to speed, and fully integrated into our programs.

I would say the other—and so we have smaller effects. We have had a reduction in travel across the board. So our examiners cannot travel extensively to conduct their examinations. We send fewer people on enforcement investigations, for example, than we might otherwise have.

But the other effect I am most concerned about is on our technology development. We have had, for example, a very major project going on for the last year to try to bring all the tips and complaints and referrals that come into the agency, tens and tens of thousands of them in every different part of the agency, bring them into a central data repository—we got that part done—with a single intake system. But now we want to build the analytics that allow us to look at all those tips and complaints and link them together, where appropriate, understand what they are telling us about trends in the marketplace with respect to products or firms or strategies, and we have had to delay for some significant period

of time our ability to launch and develop some of those analytics and things that would be very useful to us.

So, you know, we have taken all the usual things that one does under a CR. We are used to CRs. We have been under a CR a third of the time over the last 10 years.

Senator HAGAN. Wow.

Ms. SCHAPIRO. But I think it is really impacting our ability to bring on the great people we need and to get the technology developed.

Senator HAGAN. So it is definitely affecting your enforcement capabilities?

Ms. SCHAPIRO. It is in the sense that we are very leanly staffing our enforcement matters. We have always done it fairly leanly, but even more so, and we are not traveling to pursue our cases as quickly as we would like to. A lot of our cases have overseas components. We are not doing much of that because the travel is just too expensive. We are supposed to be examining credit rating agencies on an annual basis. Some of those are located in Japan. We are trying to figure out, how do we afford to send somebody to Japan for a week or 2 weeks, translators, and so forth to examine credit rating agencies when we just do not have the travel budget to do that. So it is having an impact on us, for sure.

Senator HAGAN. Some opponents of the SEC's budget will point to your growth since 2001 as a sign that it is too large, but as I understand it, your mandate and the markets under your purview have evolved dramatically over these last 10 years. Can you speak briefly about the evolution of the markets under the SEC's jurisdiction over this past decade, and in addition, what about your new ongoing regulatory responsibilities under Dodd-Frank?

Ms. SCHAPIRO. I would be happy to. You know, the markets have grown extraordinarily and we can all see that in the fact that just in the listed equities markets, 8.5 billion shares of stock trade every day worth \$220 billion. So Americans are actively engaged in the stock market right now and the market size is growing. Its complexity has grown enormously with international linkages and more of those to come, I expect, as well as the highly fragmented nature of our equity market structure now, with a dozen exchanges and ten clearing agencies and electronic communications networks and ATSS and dark pools and options markets, so we have very complex markets, as well.

We have also seen tremendous growth in the number of market participants. Investment advisors have grown 50 percent in number since 2003. Mutual funds, the number of mutual funds, the number of broker-dealers, transfer agents, all of these numbers have gotten bigger, but they have also gotten far more complex. Broker-dealers may actually be about flat, but the others have gotten larger and far more complex.

And so our job has gotten much bigger and much more prominent, and because the equity markets are the engines of capital formation in this country, debt less so, equity markets are really critical to our country's success. We think having an effective cop on the beat is important to our economy overall. Our new responsibilities, obviously, add dramatically with hedge funds, over-the-counter derivatives, and additional responsibilities for credit rating

agencies, and a whole new category of registrant called municipal advisor.

Senator HAGAN. Thank you. Thank you, Mr. Chairman.

Chairman REED. Thank you, Senator Hagan.

Senator Warner, and thank you for your patience, Senator, and also for your extraordinary contribution to the Dodd-Frank bill. He was one of the key figures in every aspect, particularly resolution, so thank you, Senator.

Senator WARNER. Thank you, Mr. Chairman, and the very kind—without an indication that actually I was here before Senator Hagan, you were just trying—

[Laughter.]

Senator WARNER. Let me again welcome Chairman Schapiro, as well, and thank you for your work.

I want to, first of all, echo what Senator Hagan has said about the nature of these 2-week CRs. We hear oftentimes from folks that we need predictability. We think about what is less predictable than running an enterprise the size of the Federal Government and an agency as important as yours with a 2-week predictability cycle. It just makes no sense at all, and again, I hope that we can reach some longer-term consensus, not just on this year's balance of the fiscal year but on a broader deficit reduction and investment plan for our country.

I want to follow up on a line of questioning that Senator Crapo raised about trying to get the balance right on regulatory oversight. Obviously, we have, and no one was more active in this particular area than the Chairman in trying to give you the ability to consolidate and bring more transparency in the securities markets. He did great, great work on that in Dodd-Frank and we have given you a big, big task.

One of the things I am concerned about in terms of the overall regulatory burden, though, you mentioned that you have got economists trying to sort through that. I think our record, not just in your agency but across the board, has been kind of spotty on that, that the nature of agencies are to always—power, prestige, and sometimes money is directly related to the volume of regulations put out and there does not seem to be an appropriate incentive in place to ever look back, and even though you have got that statutory requirement in terms of effectiveness in the market, but ever to look back and eliminate regulations that technology may have moved past or just the market conditions have moved past.

One of the things I would commend, I have been working on something that has got some challenges on it, but a regulatory pay-go approach that would say, independent of when Congress gives you a direction on kind of the normal course of regulatory oversight, when you add a regulation of a certain size and shape, you have to look at how you could perhaps remove one of similar size and shape. Now, again, it has to have appropriate checks on it. But when we have seen some on the House side actually talk about regulatory moratoriums or interjecting Congress into every regulation, I would commend you to look at this idea, this regulatory pay-go idea, before people say, oh my gosh, that would be impossible to do.

I would commend—and there is a question here—to look at the U.K., which has adopted a similar procedure called one in, one out,



and Mr. Chairman, one of the most remarkable things is that the U.K. now has passed America in terms of international competitiveness rankings, and at least when I grew up, and I know the Chairman is much younger than me, that you always kind of thought of the U.K. as the epitome of bureaucracy run amok. Just as you look at your regulatory oversight responsibilities and how you get that cost-benefit analysis right, have you looked at your colleagues and what the U.K. has done in terms of some of their regulatory reforms, and if you have not, would you be willing to take a look at that?

Ms. SCHAPIRO. We would absolutely be willing to take a look. You know, it is interesting. Sort of as we go, rule by rule, we do look at what other jurisdictions are doing, particularly with a number of our Dodd-Frank responsibilities where we want to try to be as synched up internationally as possible so we do not create either opportunities for regulatory arbitrage or an incentive for somebody to move their business out of the United States.

So we are very focused on it on a rule-by-rule basis, but I think the idea is intriguing and I would be very interested in seeing if we could find the resources to do kind of a look back as we do new rules to see what is the impact of already existing rules, do they need to stay on the books. And we are going to do that in a small business context. I am ready to ask our Commission to actually approve a Small Business Advisory Committee that will help us try to take some of those, the ideas that have been out for a long time, to facilitate the small business capital formation and see if we can turn those into hard proposals.

Senator WARNER. I would just say that I think this is not just a challenge with your agency, but just the nature of the beast is that you always are additive. There really is no incentive, unless we mandate, to actually go back and take away, and what we try to do is—and what the U.K., I think, has done—is try to get that balance right.

My time is about up, but I would ask you to come back—this will be my last question—

Chairman REED. We have had two rounds.

Senator WARNER. OK. Well, let me just make one quick comment, and that is—and I think the Chairman pointed this out as he kind of looked at the size of the market. You have come back, and you answered Senator Hagan, as well, about the growth in size. You know, there really is a challenge here around investor confidence, and we have got the challenges from the crisis in 2008. We have got the challenges from the flash crash. Your comments about broker-dealers, trying to make sure that we get that right, the important role that investors in this country, and abroad, if we do not have that cop on the beat. If you would just like to make a comment on that, I would appreciate it.

Ms. SCHAPIRO. Well, it is interesting. After the flash crash, I had many foreign regulators call me just horrified. What happened? What are you going to do? How are you going to prevent this? I mean, there was more international interest in that event directed into my office than I have seen in my 2 years at the SEC, with the possible exception of international accounting standards. It suggests to me that there is deep concern everywhere—and other mar-

kets are starting to see the kind of market structure we have developed with the prevalence of dark pools and more fractured and fragmented trading.

Senator WARNER. I might just add on this point that I remember a conversation we had about the fact that you were concerned whether we had the technological capabilities to sort through this.

Ms. SCHAPIRO. Exactly right, and so investor confidence is profoundly affected by an event like May 6, and that is why we moved so quickly to put in place the circuit breakers and to bar naked access into the markets by customers and to clarify clearly when trades would be broken and to prohibit stub quotes. For the SEC, we moved at lightning speed to get all of those things in place very quickly because it was a matter of investor confidence, and that has got to be where we keep our focus going forward, and clearly, it is where international regulators also have concern, as their markets are increasingly of interest to retail and smaller institutional investors.

Senator WARNER. And you have got to have the resources to do that and the technology to keep them.

Ms. SCHAPIRO. Exactly right.

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

Chairman REED. Thank you very much, Senator Warner.

Thank you, Madam Chairman, for your, again, your testimony. I must say, the thoughtful comments of my colleagues and your responses, I think, have added immensely to our understanding, hopefully to the public understanding, of the issues you face.

We have all talked about investor confidence. We have also talked about cost-benefit analysis, *et cetera*. But one of the descriptions of what has taken place, particularly in 2008, was a system of privatized profits and socialized losses, that when the markets are great, they can take care of themselves until they go off the rails, and then—and it is not just investors, it is taxpayers, it is everybody, directly or indirectly, losing their jobs, *et cetera*, that pays. And my sense is the SEC and CFTC and other agencies are those critical agents that ensure private profits, but also ensure that when things go bad, it is not going to be the citizen or the taxpayer that picks up the losses, either—a vital, vital role.

And just a final point, too, is that—and I think this is worth stating again—both you and the CFTC are one of the few if only financial regulatory agencies that are not funded by the industry, that you are funded through the appropriations process. We tried in the course of the deliberation of Dodd-Frank—I know Senator Schumer is going to try again—to create a system in which you are not subject to the appropriations process.

As you indicated, you explained the way it is set up is that you can adjust your fees so it does not affect the deficit, but there is a check on your ability to be the independent, vigorous, far-sighted regulator that does not affect other agencies. And frankly, I think until we get all of our financial regulators so they have that same kind of operational scope, we might encounter problems. That is just an aside. But again, I want to thank you.

And then just in terms of administrative issues, if any of my colleagues have additional questions in writing, I would ask them to

just submit these questions no later than next Thursday, March 17, prior to the St. Patrick's Day celebration to ensure the quality of the questions.

[Laughter.]

Chairman REED. And also, I would like to submit for the record letters in support of your budget from Americans for Financial Reform, CalPERS, the Federal Bar Association Executive, Law Committee Executive Council, the Financial Planning Coalition, and the North American Security Administrators Association.

In addition, the NASAA has sent a letter to the full Committee Chairman and Ranking Member supporting adequate supporting for SEC's full implementation of Dodd-Frank, and Chairman Johnson asked that I make that a part of the record today, also.

Chairman REED. I would also indicate that your written testimony, Madam Chairman, will be made part of the record *in toto*.

Senator Warner, you have a comment?

Senator WARNER. Just to again thank you for this important hearing, Mr. Chairman. But I think your very appropriate closing comments about private profit and socialized loss is critically important, and in the same spirit that you—and I fully endorse your comments of making sure that we give these cops the ability to have the resources to do their job.

I would simply again, one new tool to try to hopefully get in front of that before we see the next crisis is another outgrowth that the Chairman and I worked on together, the FSOC, and I would hope that you will continue to be diligent in making sure that becomes an important tool and kind of an early warning system for future crises. And if you feel that entity is not getting its appropriate attention, juice, recognition, and ability to do its job, I hope you will let the Chairman or I or others know.

Ms. SCHAPIRO. Absolutely.

Senator WARNER. Thank you, Mr. Chairman.

Chairman REED. Thank you, Senator Warner.

I cannot resist, but having a head of the Office of Financial Research would be very useful to FSOC—

Senator WARNER. Amen.

Chairman REED. So you can whisper that in someone's ear, Madam Chairman.

Ms. SCHAPIRO. I will mention that at our next meeting.

Chairman REED. Thank you very much.

Ms. SCHAPIRO. Thank you.

Chairman REED. If there are no further questions or comments, thank you very much, Madam Chairman.

The hearing is adjourned.

[Whereupon, at 10:46 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

**PREPARED STATEMENT OF SENATOR MIKE CRAPO**

It was recently announced that we are now facing yet another record Federal deficit at \$1.6 trillion, and the budget we recently received from the President would double the national debt, to more than \$26 trillion, by the end of the decade.

As a member of the President's National Commission on Fiscal Responsibility and Reform who voted in support of the report to confront our ever-increasing national debt, deficit, and unrestrained Federal spending I believe all agencies and programs should be prepared to sacrifice. All budgets have to be on the table.

The Dodd-Frank Act gave the SEC many new oversight responsibilities, including writing new rules, ensuring that they are enforced, and regulating new entities. The SEC will need to devote staff to these new responsibilities, particularly once the rules take effect.

The new demand for resources presents an opportunity to undertake an agency-wide examination of how existing resources are being expended and whether any of them can be better utilized. Some of the questions that need to be answered include:

What factors went into determining how many new people would be needed for each Dodd-Frank area and at what time period would they be needed?

Are there ways to use technology both to make existing staff more productive and to reduce the number of employees needed for Dodd-Frank responsibilities?

Has the SEC worked with the CFTC to share information technology development costs for the oversight of the OTC derivatives market?

While the Dodd-Frank Act missed a great opportunity to merge the SEC and CFTC and stop the bifurcation of the futures and securities markets there is no reason why we shouldn't push for more coordination, consistent rules, and budgetary savings. A recent report by GAO shows duplication among the efforts of a number of Federal programs which may cost more than \$100 billion in overlapping efforts.

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

In a short time period, the Dodd-Frank Act requires the SEC to promulgate more than 100 new rules, create five new offices, and conduct more than 20 studies and reports. The volume of this rulemaking and an unrealistic Congressional timeline poses significant challenges to the SEC.

The likely impact of the Dodd-Frank Act will be enormous, and we will have no idea of the actual costs for years to come. Given prior experience, such as the original estimates about the cost of the Sarbanes-Oxley Act of 2002, these actual costs will prove substantially more significant than legislators and regulators have predicted.

It is more important that the SEC allows for meaningful public comment and economic analysis than it is to rush through these rules and risk undermining the integrity of the process. The potential harm to our already weak economy and the public from ill-conceived rules cannot be underestimated.

**PREPARED STATEMENT OF MARY L. SCHAPIRO**

CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

MARCH 1, 2011

Chairman Reed, Ranking Member Crapo, Members of the Subcommittee: Thank you for the opportunity to testify in support of the President's FY2012 budget request for the U.S. Securities and Exchange Commission (SEC).<sup>1</sup> I welcome this opportunity to answer your questions and provide you with additional information on how the SEC would make effective use of the \$1.407 billion that is requested for the coming fiscal year.<sup>2</sup>

Over the past 2 years, we have worked tirelessly to make the SEC more vigilant, agile, and responsive, and are moving on multiple fronts to enhance the agency's effectiveness and provide robust oversight of the financial markets. We have new senior leadership in all key positions and have embarked on a vigorous rulemaking agenda, addressing areas such as equity market structure, investment adviser cus-

<sup>1</sup> A copy of the SEC's FY2012 Budget Congressional Justification can be found on our Web site at <http://www.sec.gov/about/secfy12congbudgjust.pdf>.

<sup>2</sup> The views expressed in this testimony are those of the Chairman of the Securities and Exchange Commission and do not necessarily represent the views of the President or the full Commission.

tody controls, money market fund resiliency, asset-backed securities, large trader reporting, pay-to-play, and municipal securities disclosure.

In addition to carrying out our longstanding core responsibilities, last year's enactment of the Dodd-Frank Act has added significantly to the SEC's workload. In the short term, it requires the agency to promulgate more than 100 new rules, create five new offices, and produce more than 20 studies and reports. The law assigns the SEC considerable new responsibilities that will have a significant long-term impact on the agency's workload, including oversight of the over-the-counter (OTC) derivatives market and hedge fund advisers; registration of municipal advisors and security-based swap market participants; enhanced supervision of nationally recognized statistical rating organizations (NRSROs) and clearing agencies; heightened regulation of asset-backed securities (ABS); and creation of a new whistleblower program.

My testimony will provide an overview of the agency's actions and initiatives over the past year. I will then discuss the FY2012 budget request and the activities that these resources would make possible.

### **New Leadership, Organizational Reform, and Expertise**

Without a doubt, the most critical element to our success in improving the Commission's operations is the agency's talented staff. Over the past 2 years, we have installed new management across the major divisions and offices of the Commission. These new senior managers are playing a vital role in our efforts to transform the agency.

During my first year, we brought in new leadership to run the 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 created a new Division of Risk, Strategy, and Financial Innovation to refocus the agency's attention on—and response to—new products, trading practices, and risks.

This past year, we brought on board a new director to oversee the Division of Investment Management, and hired deputy directors in the Divisions of Trading and Markets and Corporation Finance. We also brought on board key leaders to help improve internal operations. This includes the creation of a new Chief Operating Officer position; the hiring of a new Chief Financial Officer to oversee the agency's budget, accounting, and financial reporting; the hiring of a new Chief Information Officer to oversee the agency's information technology program; and the hiring of the agency's first Chief Compliance Officer. At all levels we have focused on hiring individuals with key skill sets that reflect the rapidly changing markets under our supervision.

We're continuing to make significant progress in reforming how the SEC operates. Since 2009, the agency has carried out a comprehensive review and restructuring of its two largest programs—enforcement and examinations—to ensure effective performance. The Enforcement Division has streamlined its procedures to bring cases more swiftly, removed a layer of management, created national specialized units, and added new staff with new skills to pursue complex fraud and market abuses. More recently, the SEC's examinations unit restructured its exam program after a top-to-bottom review, becoming more risk-based in its approach, enhancing staff training, and installing better systems to support examiners.

In addition, the Division of Corporation Finance recently made targeted changes to its operations to help us: address complexities and changes in the asset-backed securities market; determine if our rules, regulations, and review approach are adequately addressing trends in securities offerings and in our capital markets; and enhance our focus on the largest financial institutions.

Also during the past year, to the extent permitted by available resources, we worked to improve training and education of agency staff, to establish a deeper reservoir of experts throughout the agency, and to modernize information technology, including a centralized system for tips and complaints, enforcement and examination management systems, risk analysis tools, and financial management systems.

### **Enforcing the Law**

Enforcement of the securities laws is the foundation of the SEC's mission. Swift and vigorous proceedings directed at those who have broken the law are at the heart of the agency's efforts to protect investors.

In the past year, the SEC has continued our structural reforms of the enforcement program. We have created five national specialized investigative groups dedicated to high-priority areas of enforcement; adopted a flatter organizational structure to permit more staff to be allocated to front-line investigations; and created a new Of-

office of Market Intelligence to serve as the hub for the effective handling of tips, complaints, and referrals.

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

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

These reforms, which were intended to maximize our use of resources and permit the agency to move more swiftly and strategically, are already showing improvements. Over the past calendar year, court-ordered disgorgements are up 20 percent, while the amount of monetary penalties has almost tripled. Of course, numbers alone don't fully capture the complexity, range, or importance of our enforcement accomplishments. During the past year, the Commission:

- brought significant actions involving issues arising from the financial crisis, including actions against the former Chief Executive Officer (CEO) and other executives of Countrywide Financial, Citigroup and its former Chief Financial Officer (CFO) and Head of Investor Relations, Morgan Keegan, Goldman Sachs, State Street Bank, former executives of New Century Financial and IndyMac Bancorp, Brookstreet Securities, and ICP Asset Management and its President;
- obtained multimillion dollar settlements with Tyson Foods, Alcatel-Lucent, Technip, and General Electric for violations of the Foreign Corrupt Practices Act (FCPA);
- filed our first case against a State involving municipal securities;
- brought accounting fraud cases against Dell, Diebold, and DHB Industries;
- brought a significant case alleging inappropriate use of confidential customer information by a proprietary trading desk at Merrill Lynch and an action against AXA Rosenberg in the challenging and rapidly evolving area of computer-based quantitative investment management;
- filed a variety of cases to halt Ponzi scheme operators and perpetrators of offering frauds, including those brought in conjunction with the Financial Fraud Enforcement Task Force's Operation Broken Trust sweep—indeed, in each of the past two fiscal years we've filed more than twice as many Ponzi cases as we filed in fiscal 2008;
- brought actions alleging illegal trading on confidential information obtained from technology company employees moonlighting as expert network consultants and illegal trading by major hedge funds based on illegal tips; and
- brought an action alleging a \$1.5 billion mortgage securities fraud scheme to defraud the U.S. Treasury's Troubled Asset Relief Program (TARP).

#### **Strengthening Oversight**

Strong regulation is essential to the fair, orderly, and efficient operation of markets. A vigorous examination program not only reduces the opportunities for wrongdoing and fraud, but also provides early warning about emerging trends and potential weaknesses in compliance programs.

This past year, the SEC reorganized the agency's national examination program in response to rapidly changing Wall Street practices and lessons learned from the Madoff and Stanford frauds. The agency strengthened the national exam program to provide greater consistency and efficiencies across our eleven regions and to focus more sharply on identifying the higher risk firms that it targets for examination. We also implemented new policies requiring examiners to routinely verify the existence of client assets with third party custodians, counterparties, and customers. Additionally, the exam unit now assembles individual specialists with the appropriate skill-sets for the firm they are examining or the issues on which they are focusing.

Finally, the SEC has also worked to enhance the training of examiners and bring on board specialists in risk management, trading, and complex structured products.

These reforms are helping to deliver results in the exam program's work to evaluate risks, inform policy, and identify potential wrongdoing. In fact, in January 2011 alone, the Enforcement Division brought three significant cases stemming directly from exams. And going forward, the national exam program will continue to conduct sweeps in critical areas from trading practices to market manipulation to structured products.

### **Improving Market Structure**

No discussion of the SEC's actions over the past year would be complete without a discussion of May 6, 2010—the day our markets dropped more than 500 points in a matter of minutes, only to bounce back minutes later. That event reinforced the importance of our ongoing review of market structure, which we had launched months earlier with a concept release inviting comment on regulation of the changing financial markets.

The U.S. equity market structure has changed dramatically in recent years. A decade ago, most of the volume in stocks was executed manually, whether on the floor of an exchange or over the telephone between traders. Now nearly all orders are executed by fully automated systems at great speed. The fastest exchanges and trading venues are now able to accept, execute, and send a response to orders in less than one thousandth of a second.

Speed is not the only thing that has changed. As little as 5 years ago, the great majority of U.S. equities capitalization was traded on a listing market—the New York Stock Exchange (NYSE)—that executed nearly 80 percent or more of volume in those stocks. Today, the NYSE executes approximately 22 percent of the volume in its listed stocks. The remaining volume is split among 15 public exchanges, more than 30 dark pools, 3 electronic communication networks (ECNs), and more than 200 internalizing broker-dealers. Currently, more than 30 percent of the volume in U.S.-listed equities is executed in venues that do not display their liquidity or make it generally available to the public, reflecting an increase over the last year.

The evolution of trading technologies has dramatically increased the speed, capacity, and sophistication of the trading functions that are available to market participants. The new electronic market structure has opened the door for entirely new types of professional market participants. Today, proprietary trading firms play a dominant role by providing liquidity through the use of highly sophisticated trading systems capable of submitting many thousands of orders in a single second. These high-frequency trading firms can generate more than a million trades in a single day and now account for more than 50 percent of equity market volume.

Public feedback from a wide variety of market participants has been that today's market structure clearly offers many advantages, including reduced trading costs, when compared to the markets of ten, and even just 5 years ago. Nevertheless, as highlighted by the events of May 6, the current structure has many potential issues that should be studied and addressed where appropriate. High-speed, algorithm-driven electronic trading has increased the risk of sudden liquidity imbalances that can lead to disorderly market conditions and unexpected volatility. The continuing growth of trading in dark pools and other types of dark venues can challenge the quality of the market's price-discovery function. And the complexity of the market structure sometimes makes it difficult for even sophisticated investors to pursue their own best interests.

Over the past year, the SEC has engaged in a dedicated effort to study and learn from the experiences of May 6, with the aim of taking action to preserve the benefits of the current structure while minimizing its downsides. The agency worked with FINRA and the exchanges to develop rules that trigger circuit breakers for certain individual stocks, clarify up front how and when erroneous trades would be broken, and effectively prohibit "stub quotes" in the U.S. equity markets. We adopted a rule that prohibits broker-dealers from providing their clients with unfiltered access to exchanges, and proposed the creation of a large trader reporting system that would enhance our ability to identify large market participants, collect information on their trades, and analyze their trading activity.

We also proposed a new rule that would require the creation of a consolidated audit trail that would enable regulators to track information about trading orders received and executed across the securities markets. Today, there is no standardized, automated system to collect data across the various trading venues, products, and market participants. Each market has its own individual and often incomplete data collection system, and as a result, regulators tracking suspicious activity or reconstructing an unusual event must obtain and merge an immense volume of disparate data from a number of different markets. And even then, the data does not

always reveal who traded which security, and when. To obtain individual trader information, the SEC must make a series of manual requests that can take days or even weeks to fulfill. In brief, the Commission's tools for collecting data and surveilling our markets are wholly inadequate to the task of overseeing the largest equity markets in the world.

The proposed consolidated audit trail rule would require the exchanges and FINRA to jointly develop a national market system (NMS) plan to create, implement, and maintain a consolidated audit trail in the form of a newly created central repository. The information would capture each step in the life of the order, from receipt or origination of an order, through the modification, cancellation, routing and execution of an order. Notably, this would include information identifying the "ultimate customer" who generated the order. And, it would require members to "tag" each order with a unique order identifier that would stay with that order throughout its life.

If implemented effectively, the consolidated audit trail would, for the first time, allow self-regulatory organizations (SROs) and the Commission to track trade data across multiple markets, products and participants simultaneously. It would allow us to rapidly reconstruct trading activity and to more quickly analyze both suspicious trading behavior and unusual market events. It is important to recognize, however, that the consolidated audit trail is a major change in the technology infrastructure for our equity markets, and thus will require some time to fully implement. In addition, in order to fully use this new infrastructure, the Commission's own technology and human resources will need to be expanded well beyond their current levels.

### Key Rulemaking

Over the past year, the Commission has pursued an active rulemaking agenda aimed at making our financial markets more secure, providing investors with more and better information, finding ways to make securities markets less volatile and more transparent, and promoting effective corporate governance. Even before passage of the Dodd-Frank Act, the SEC was in the midst of a productive period of rulemaking on diverse topics. Among the key ongoing and recently completed rulemakings are the following:

- *Municipal securities*: The Commission adopted rules that provide market participants with more meaningful and timely information regarding the health of municipal securities. In addition, as discussed below, we adopted rules to curtail pay to play practices by investment advisers seeking to manage public pensions.
- *Proxy enhancements*: The Commission adopted rules to facilitate exercise of shareholders' traditional State law right to nominate directors to corporate boards. We also improved disclosure relating to risk and compensation and revised the e-proxy rules so that additional materials could be provided to shareholders with the company's notice. And, we issued a concept release requesting public input on the mechanics of proxy voting and shareholder communications.
- *Investment adviser disclosure*: In order to ensure that investors receive clear and accurate information from their advisers, the Commission adopted rules requiring advisers to provide clients with brochures that plainly disclose their business practices, fees, conflicts of interests, and disciplinary information.
- *Mutual funds fees and marketing*: The Commission proposed rules to create a more equitable framework for mutual fund marketing fees, known as 12b-1 fees. We proposed rules to help clarify the meaning of a date in a target date fund's name, as well as enhance information in fund advertising and marketing materials.
- *Target date funds*: The Commission proposed rules that are intended to provide enhanced information to investors concerning target date retirement funds and reduce the potential for investors to be confused or misled regarding these funds.
- *Money market funds*: The Commission took action to permit investors, for the first time, to access detailed information that money market funds now file with the agency, including their "shadow NAV" (net asset value). While the SEC uses this information in its real-time oversight of money market funds, public disclosure can provide investors and market analysts with useful insight for their evaluation of funds. We also tightened the quality standards that apply to the funds' investments and are working with our regulatory colleagues to assess the various options for making sure these funds are as safe and resilient in the face of market stresses as investors are led to believe.



- *Asset-backed securities*: The Commission proposed rules that would revise the disclosure, reporting and offering process for ABS to better protect investors in the securitization market.
- *Market access*: The Commission took an important step to promote market stability by adopting a new market access rule. Broker-dealers that access the markets themselves or offer market access to customers will be required to put in place appropriate pretrade risk management controls and supervisory procedures. The rule effectively prohibits broker-dealers from providing customers with “unfiltered” access to an exchange or alternative trading system. By helping ensure that broker-dealers appropriately control the risks of market access, the rule should prevent broker-dealers from engaging in practices that threaten the financial condition of other market participants and clearing organizations, as well as the integrity of trading on the securities markets.
- *Pay to Play*: The Commission adopted in June of last year a new rule to address so-called “pay to play” practices in which investment advisers make campaign contributions to elected officials in order to influence the award of contracts to manage public pension plan assets and other Government investment accounts. The rule, adopted in response to a growing number of reports of such activities across the country, is intended to combat pay to play arrangements at the State and local Government level in which advisers are chosen based on their campaign contributions to political officials rather than on merit.

In addition to these items, enactment of the Dodd-Frank Act added significant new work to the Commission’s agenda, including more than 100 rulemaking provisions applicable to the SEC. To date, the Commission has issued twenty-eight proposed rule releases, seven final rule releases, and two interim final rule releases in connection with the Dodd-Frank Act. We have received thousands of public comments, held hundreds of meetings with market participants, completed five studies, and hosted five roundtables. Among the areas of current focus:

- *OTC derivatives*: We are working with the Commodity Futures Trading Commission (CFTC) to implement the new regulatory regime for OTC derivatives—defining terms, developing requirements for new trading and clearing platforms, crafting registration and reporting regulations, carving out end-user exemptions, and undertaking dozens of other tasks.
- *Private fund advisers*: We are working to finalize rules to implement the requirement that advisers to large hedge funds and private equity funds register with the Commission. Additionally, we’re working with members of the Financial Stability Oversight Council and the CFTC to implement the Act’s mandate that advisers to hedge funds and other private funds report information for use in monitoring for systemic risk to the U.S. financial system.
- *Asset-backed securities*: Along with the banking regulators, we are working to propose risk-retention (or “skin in the game”) requirements for asset-backed securities transactions. And under recently adopted rules, ABS issuers, for the first time, will be performing reviews of the bundled assets and disclosing the nature, findings, and conclusions of these reviews. The Commission also adopted rules regarding representations and warranties in ABS. In addition, we are working to sync up our earlier ABS proposed rules with those adopted under the Dodd-Frank Act.
- *Credit rating agencies*: The Commission is working on about a dozen rulemakings related to NRSROs, including with respect to internal controls, conflicts of interest, credit rating methodologies, transparency, ratings performance, analyst training, credit rating symbology, and disclosures accompanying the publication of credit ratings.
- *Corporate governance*: The Commission is working on rules to implement the Act’s various provisions relating to public company governance, including recently adopted rules on shareholder advisory votes on executive compensation, as well as rules with respect to the independence of compensation committees, retention of compensation consultants, incentive-based compensation regulations or guidelines for certain large financial institutions, clawbacks of executive compensation, pay for performance, pay ratios, and broker voting of uninstructed shares.
- *Studies related to investment advisers and broker-dealers*: To date, the Commission has published three staff studies on enhancing investment adviser examinations, the obligations of investment advisers and broker-dealers, and investor access to information about investment professionals. We will begin to consider rules stemming from these recent studies, including consideration of the recommendation that financial professionals who provide personalized investment

advice to retail customers about securities adhere to a fiduciary standard of conduct “no less stringent” than that currently imposed on investment advisers.

- *Rewards for whistleblowers:* The Commission will be finalizing rules that will allow us to benefit more effectively from input by whistleblowers, the individuals who are often closest to fraud and can be an invaluable source of information for our enforcement and inspection efforts.
- *Specialized Disclosures:* Title XV of the Dodd-Frank Act contains specialized disclosure provisions related to conflict minerals, coal or other mine safety, and payments by resource extraction issuers to foreign or U.S. Government entities. The Commission published the rule proposals relating to these three provisions in December 2010. The comment periods were scheduled to close on January 31, 2011, but the Commission extended the comment periods for all three rule proposals for 30 days, to March 2, 2011 after receiving several requests for an extension of the time for public comment.

### **SEC Resources**

This year finds the SEC at an especially critical juncture in its history. Not only does the Dodd-Frank Act create significant additional work for the SEC, both in the short and long term, but the agency must also continue to carry out its longstanding core responsibilities. These responsibilities—pursuing securities fraud, reviewing public company disclosures and financial statements, inspecting the activities of investment advisers and broker-dealers, and ensuring fair and efficient markets—remain essential to investor confidence and trust in financial institutions and markets.

Over the past decade, the SEC has faced significant challenges in maintaining a staffing level and budget sufficient to carry out its core mission. The SEC experienced 3 years of frozen or reduced budgets from FY2005 to 2007 that forced a reduction of 10 percent of the agency’s staff. Similarly, the agency’s investments in new or enhanced information technology (IT) systems declined about 50 percent from FY2005 to 2009.

As a result of increased funding levels in FY2009 and FY2010, current SEC staffing levels are just now returning to the level of FY2005, despite the enormous growth in the size and complexity of the securities markets since then. During the past decade, for example, trading volume has more than doubled, the number of investment advisers has grown by 50 percent, and the assets they manage have increased to \$38 trillion. Six years ago, the SEC’s funding was sufficient to provide nineteen examiners for each trillion dollars in investment adviser assets under management. Today, that figure stands at twelve examiners per trillion dollars. A number of financial firms spend many times more each year on their technology budgets alone than the SEC spends on all of its operations.

Today, the SEC has responsibility for approximately 35,000 entities, including direct oversight of 11,800 investment advisers, 7,500 mutual funds, and more than 5,000 broker-dealers with more than 160,000 branch offices. We also review the disclosures and financial statements of approximately 10,000 reporting companies. The SEC also oversees approximately 500 transfer agents, 15 national securities exchanges, 9 clearing agencies, 10 nationally recognized statistical ratings organizations (NRSROs), as well as the Public Company Accounting Oversight Board (PCAOB), Financial Industry Regulatory Authority (FINRA), Municipal Securities Rulemaking Board (MSRB), and the Securities Investor Protection Corporation (SIPC).

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

### *FY2011 Continuing Resolution*

The SEC has not yet received any additional funds in FY2011 for its new responsibilities under the Dodd-Frank Act. For FY2011, the President’s budget request for

the SEC was \$1.258 billion, which would have constituted an increase over the SEC's FY2010 appropriation of \$1.111 billion. However, the SEC did not receive this request, and since the start of FY2011 has been operating under continuing resolutions that provide funding at last year's levels, despite the fact that the agency must sustain a larger workforce than it did last year. This restricted funding has required the SEC to severely restrain any new hiring this year, even to replace staff who leave the agency; to postpone most technology initiatives; and to limit its base mission operations until the final funding level for FY2011 is resolved.

As discussed above, the enactment of the Dodd-Frank Act has added significantly to the SEC's workload. So far, the SEC has proceeded with the first stages of implementation of the Dodd-Frank Act without additional funding. This has largely involved performing studies, conducting analyses, and writing rules. These tasks have taken staff time from other responsibilities, and have been done almost entirely with existing staff. Over the long-term, fulfilling the Act's new oversight responsibilities—for instance, with respect to the OTC derivatives market, hedge fund advisers, municipal advisers, security-based swap participants, NRSROs, clearinghouses, asset-backed securities, and whistleblowers—will require significant additional resources or a substantial reduction in the performance of our core duties. In acknowledgement of this new workload, the Act authorized an increase in the agency's budget to \$1.5 billion in FY2012, and \$2.25 billion by FY2015.

#### *FY2012 Request*

The SEC is requesting \$1.407 billion for FY2012, an increase of \$264 million over the continuing resolution level under which we are currently operating. If enacted, this request would permit us to hire an additional 780 positions (612 FTE) over projected FY2011 levels.

It is important to note that the SEC's FY2012 funding request would be fully offset by matching collections of fees on securities transactions. Currently, the transaction fees collected by the SEC are approximately two cents per \$1,000 of transactions. Under the Dodd-Frank Act, beginning with FY2012, the SEC is required to adjust fee rates so that the amount collected will match the total amount appropriated for the agency by Congress. Under this mechanism, SEC funding will be deficit-neutral, as any increase or decrease in the SEC's budget would result in a corresponding rise or fall in offsetting fee collections.

The FY2012 request is designed to provide the SEC with the resources required to achieve several high-priority goals: to adequately staff the agency to fulfill its core mission; to continue to implement the requirements of the Dodd-Frank Act; and to expand the agency's IT systems and management infrastructure to serve the needs of a more modern and complex organization. For purposes of my testimony today, I would like to summarize the request in each of these priority areas:

- *Reinvigorating Core SEC Programs:* 40 percent (312) of the new positions requested for FY2012 would be used to strengthen and support core SEC operations, including protecting investors, maintaining orderly and efficient markets, and facilitating capital formation. As mentioned before, SEC staffing levels are just now returning to FY2005 levels, even as the agency's responsibilities have grown along with the size and complexity of the securities markets. To help restore core capabilities, this budget request would permit us to add forty-nine positions to the enforcement program that would grow the five new specialized investigative units, bolster the agency's litigation program, and expand the new Office of Market Intelligence which conducts risk assessment and handles thousands of tips, complaints, and referrals. In our examination program, this request would allow us to add fifty-five personnel to augment risk assessment, monitoring, and surveillance functions and to conduct additional adviser and fund inspections. The request would also permit thirty-seven staff to be added to the Division of Corporation Finance primarily to conduct more frequent disclosure reviews of the largest companies, fifteen additional staff to the Division of Investment Management primarily to enhance oversight of money market funds and specialized products, and eleven new positions to be added to the Division of Risk, Strategy, and Financial Innovation to better equip the agency to identify and address emerging risks and long-term issues of critical importance.
- *Implementing the Dodd-Frank Act:* 60 percent (468 positions) of the new positions requested for FY2012 would be used to implement the Dodd-Frank Act. Many of these new positions would be used to hire experts in derivatives, hedge funds, data analytics, credit ratings, and other new or expanded responsibility areas, so that the agency may acquire the deeper expertise and knowledge needed to perform effective oversight. These new positions would support 157 new positions focused on the derivatives markets; 102 focused on hedge fund advis-

ers; 43 to expand investigations of tips received from whistleblowers; 35 focused on municipal securities and examinations of newly registered municipal advisors; 33 focused on clearing agencies, including annual reviews of those determined to be systemically important; and 26 focused on NSRSOs principally to perform the annual examinations required by the Act. The agency also would invest in technology to facilitate the registration of additional entities and capture and analyze data on the new markets.

The total FY2012 costs to implement the Dodd-Frank Act through these new positions and technology investments will be approximately \$123 million. In addition to the new positions requested in FY2012, we also anticipate that an additional 296 positions and additional technology investments will be required in FY2013 for full implementation of the Dodd-Frank Act.

- *Investing in Information Technology:* The SEC's budget request for FY2012 will support information technology investments of \$78 million, an increase of \$23 million over FY2011. This level of funding would support vital new technology initiatives including data management and integration, document management, EDGAR modernization, market data, internal accounting and financial reporting, infrastructure functions, and improved project management. This funding will permit the agency to develop risk analysis tools to assist with triage and analysis of tips, complaints, and referrals and to complete a digital forensics lab that enforcement staff can use to recreate data from computer hard drives and cell phones to capture evidence of sophisticated frauds. The budget request would also permit the hiring of additional staff in the Office of Information Technology, including experienced business analysts and certified project managers to oversee IT projects and staff to address financial statement and information technology deficiencies identified by the Government Accountability Office (GAO).
- *Improving the Agency's Management Infrastructure:* The SEC's FY2012 request would permit the SEC to make further improvements to the agency's basic internal operations and to bring administrative and support services capabilities into alignment with the requirements of today's SEC, and ensure that the agency manages its resources wisely and efficiently. The budget request would permit the strengthening of the newly established Office of the Chief Operating Officer, including the development of a more robust operational risk management program and the build-out of a data management program. The budget request also contemplates an appropriate expansion of the agency's administrative support functions, including the Offices of Financial Management, Human Resources, Administrative Services, and FOIA and Records Management. The request also includes the necessary space rent and other noncompensation expenses necessary to support the level of staffing requested for FY2012. Additionally, the SEC is devoting significant management attention to improving program and management controls, including in response to audits and assessments by the Office of the Inspector General (OIG), GAO, and management's own internal assessments.
- *Addressing Material Weaknesses in Internal Controls:* In November 2010, the SEC completed its Performance and Accountability Report, the equivalent of a company's annual report. A GAO audit found that the financial statements and notes included in the report were presented fairly and in conformity with U.S. Generally Accepted Accounting Principles (GAAP), but also identified two material weaknesses in internal controls over financial reporting: one in information systems, and a second in financial reporting and accounting processes.

I find these material weaknesses unacceptable. The root causes of these weaknesses are gaps in the security and functionality of the agency's financial system, resulting from years of underinvestment in financial systems technology. Rather than incur the development risks of creating new technology and systems, we made the decision to outsource this function by migrating to one of the Office of Management and Budget's designated Federal Shared Service Providers (FSSP), under the Financial Management Line of Business (FMLoB) model.

After detailed analysis and careful consideration, the Commission selected as its FSSP the Department of Transportation's (DOT) Enterprise Service Center (ESC). Through the implementation of the new financial system, the Commission will reap the benefits of expanded functional capability; business process reengineering, where appropriate; and better integration of program, financial, and budgetary information to support more efficient and effective operations.

In November 2010, the SEC began the planning phase of the financial management improvement project, which focused on the development of a detailed project plan for the full implementation of the ESC solution and the identification of unique

Commission requirements. The SEC and the ESC just completed the planning phase, and on February 25 signed an interagency agreement to commence the implementation phase. We will work together over the next thirteen months to migrate the SEC's financial system and data, with a planned cutover in April 2012.

**Conclusion**

Thank you, again, for your support for the agency's mission, and for allowing me to be here today to present the President's budget request. I am happy to answer any questions that you might have.

**RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN REED  
FROM MARY L. SCHAPIRO**

**Q.1.** How has market transaction activity changed from 2001 to the present?

**A.1.** Market transaction activity has changed dramatically over the last 10 years. For example, in the equity markets, the average daily share volume in U.S.-listed stocks increased from 3.4 billion shares in 2001 to 8.5 billion shares in 2010. As discussed in the Commission's January 2010 concept release on equity market structure,<sup>1</sup> the changes have been particularly profound for stocks listed on the NYSE. NYSE-listed stocks represent approximately 80 percent of U.S. market capitalization and traditionally were traded in a largely centralized fashion on a physical trading floor. In January 2005, for example, the NYSE executed 79.1 percent of the 2.1 billion shares in average daily volume in its listed stocks. By October 2009, it executed only 25.1 percent of the 5.9 billion shares of average daily volume. The remaining 74.9 percent of volume in NYSE-listed stocks was executed by approximately 15 exchanges and electronic communications networks, approximately 32 dark pool alternative trading systems, and more than 200 internalizing broker-dealers.

The nature of trading in NYSE-listed stocks also changed dramatically during the period from 2005 to 2009 as the NYSE adopted a more automated trading model and many market participants began to use automated trading tools and strategies. The average speed of execution on the NYSE, for example, declined from 10.1 seconds to 0.7 seconds for small, immediately executable orders. The number of average daily trades increased from 2.9 million to 22.1 million, even as the average trade size declined from 724 to 268 shares.

**Q.2.** What has the SEC done to enact Section 939G of the Dodd-Frank Act?

**A.2.** Section 939G was effective upon enactment of the Dodd-Frank Act and immediately repealed SEC Rule 436(g). As you know, Rule 436(g) exempted nationally recognized statistical rating organizations (NRSROs) from having to be named as experts and consenting to being named when their ratings are included in a registration statement. Before the repeal, Rule 436(g) had the effect of exempting NRSROs from expert liability under Section 11 of the Securities Act of 1933. The repeal of this rule meant that issuers would be required to file the consent of an NRSRO named in a registration statement, when that registration statement includes the credit rating of the security being offered and sold.

The immediate impact of the repeal of Rule 436(g) was in the area of public offerings of asset-backed securities (ABS). As discussed in detail below in the response to your Question 3, the staff of the Division of Corporation Finance has issued two no-action letters in order to facilitate the registered ABS market.

**Q.3.** What enforcement or other tools has the SEC deployed to ensure orderly, efficient markets and facilitate capital formation in

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<sup>1</sup> See, <http://sec.gov/rules/concept/2010/34-61358fr.pdf>.

light of the events in the asset-backed securitization market on July 22, 2010?

**A.3.** Under the current rules for ABS offerings, ABS registration statements are required to include information regarding the rating if the sale is conditioned on the issuance of a rating. Therefore, any registered offering of ABS that is conditioned on receiving a rating would be required to include consent by the rating agency that issued the rating for the securities, to be named as an expert in the registration statement. The staff was advised by NRSROs at the time of enactment of the Dodd-Frank Act that they would not be willing to provide such consent, which, in turn, would have caused issuers to be unable to register ABS offerings and move ABS offerings to the unregistered private markets.

Therefore, on July 22, 2010, the staff of the Division of Corporation Finance issued a no action letter to Ford Motor Credit Company LLC as a temporary measure to enable ABS issuers to continue to conduct registered offerings while the SEC and market participants determine an appropriate long-term solution to the issue. The letter stated that the Division will not recommend enforcement action to the Commission if an asset-backed issuer as defined in Item 1101 of Regulation AB omits the ratings disclosure required by Regulation AB from a prospectus that is part of a registration statement relating to an offering of asset-backed securities. This no-action position was set to expire on January 24, 2011.

The staff met with the major NRSROs, who continue to indicate they will not provide their consent. This means that without some action, all ABS offerings would be conducted in the unregistered private markets. Given the current state of uncertainty in the ABS market and the benefits to investor protection afforded by Securities Act registration, the staff believed the best balance at this time was to extend the no-action position. The staff extended the relief until further notice in a second letter to Ford Motor Credit issued on November 23, 2010.

The Commission has been focused on rating agency issues generally and had outstanding proposals and requests for comment in this area when the Dodd-Frank Act was enacted. We currently are working on extensive changes to our regulations that would improve several aspects of asset-backed securities regulation and securities ratings, including changes to the oversight of NRSROs and the removal of ratings' reliance from the Commission's regulations. We also understand that some of the newer rating agencies may consider agreeing to the required consent for ratings that are disclosed in a prospectus. We continue to monitor the issue and we will carefully consider your comments as we move forward in our efforts.

Because ratings are not required to be disclosed in non-ABS offerings, ratings relating to the securities being offered and sold are not typically included in corporate registration statements. However, other rating information is sometimes included in registration statements, such as in Management's Discussion and Analysis. Therefore staff of the Division of Corporation Finance also issued guidance to corporate registrants regarding disclosure of ratings in other contexts to facilitate continued compliance with disclosure rules without prompting a need for rating agency consent.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR SCHUMER  
FROM MARY L. SCHAPIRO**

**Q.1. *Coordination With the CFTC.*** Chairman Schapiro, the Dodd-Frank Act requires that the SEC and CFTC coordinate their rule makings. Moreover, it would seem to be common sense that similar products (credit derivatives and indexes of credit derivatives, for example) should be subject to the same set of rules, especially with respect to such fundamental issues as market structure.

Yet, the SEC and CFTC have proposed different sets of rules pertaining to “securities-based swap execution facilities” and “swap execution facilities”, respectively. I am concerned that conflicting or inconsistent rules on such fundamental areas as market structure could drive business to overseas markets, where market structure will be consistent across similar product classes. What steps is the SEC taking to ensure that U.S. markets are not put at a disadvantage to non-U.S. markets as a result of a lack of consistency between the SEC’s and CFTC’s rules?

**A.1.** Commission staff has consulted and coordinated extensively with the CFTC staff in the development of the proposed rules. Our objective has been to establish consistent and comparable requirements, to the extent possible, given the differences in the swaps and security-based swap markets, and we will continue to strive for increased coordination and harmonization where appropriate as we move toward adoption of final rules.

For example, Commission staff worked closely with the CFTC staff in crafting the swap and security-based swap execution facility proposals, and overall there are substantial similarities between the proposals. There are, however, differences in certain areas, such as the treatment of requests for quotes, block trades, and voice brokerage. Our proposal reflects the SEC’s preliminary view as to how the Dodd-Frank Act would best be applied to the trading of security-based swaps. We look forward to input from the public as to whether these differences are supported by distinctions in the trading and liquidity characteristics of swaps and security-based swaps, or whether the agencies’ rules may be further harmonized—and if so, how. Based on the feedback we receive, we plan to work with the CFTC to achieve greater harmonization of the rules for SEFs and security-based SEFs. In addition, we have been reviewing the CFTC’s proposals in conjunction with our own to identify areas where it makes sense to further harmonize our proposed rules.

As the Commission engages in the Title VII rulemaking process, we recognize the need to establish regulation that is in accordance with the requirements under Title VII and that also takes into account the global nature of the derivatives marketplace. We are mindful of the potential for regulatory arbitrage, which could impact the competitiveness of U.S. derivatives markets and U.S. entities in the global derivatives markets, as well as undermine the goals of Title VII.

In addition to our consultation and coordination with the CFTC and other U.S. regulators, we have been engaged in ongoing bilateral and multilateral discussions with foreign regulators and have been speaking with many foreign and domestic market participants in order to better understand which areas of derivatives regulation



pose such arbitrage opportunities. We have solicited and welcome comments on our proposed rulemakings regarding the potential impact they may have on the position of the U.S. derivatives markets, especially comments that offer suggestions for mitigating regulatory arbitrage opportunities while achieving the goals of Title VII. However, given the complicated, interwoven nature of these matters, we have sought to avoid a piecemeal approach through the rules we have proposed thus far.

**Q.2. *Timing.*** Chairman Schapiro, it appears to be a fact that, despite the best efforts of the Commission and its staff, and despite the best efforts of the CFTC and its staff, not every deadline prescribed by Dodd-Frank will be met. As part of your efforts to coordinate with the CFTC, has there been any discussion about which rules to prioritize in the event it is not possible to issue all the rules by their stated deadlines?

Also, has the SEC developed a plan for appropriate staging of the various rules in the event all deadlines are not met? For example, some commentators have suggested that rules regarding transparency and trade reporting should be prioritized, to ensure that the SEC and CFTC have as much relevant data as possible when implementing other rules, such as position limits. Is that an approach the SEC is considering?

**A.2.** We continue to work towards completing the rulemaking proposal and adoption process under Dodd-Frank within Congress' deadlines for implementation. However, given the complex issues raised by OTC derivatives, this is a very challenging task. We are progressing at a deliberate pace, taking the time necessary to thoughtfully consider the issues before proposing specific rules, and will continue to do so as we move toward adoption. We believe that this approach will help ensure that, when finally adopted, these rulemakings serve the broader objective of providing a workable framework that allows the OTC derivatives market to continue to develop in a more transparent, efficient, accessible, and competitive manner.

As we consider final rules, we are focused on how to sequence the compliance dates of the various rules under Title VII to allow market participants sufficient time to develop the policies, operations and technology that they need in order to comply. We are carefully reviewing comments that we have received on appropriate approaches to implementation, and hope to receive more input on these issues. Jointly with the CFTC, in May we hosted a 2-day public roundtable to hear from market participants on implementation issues and supplement the comments received to date. In developing a sequencing plan, we are also considering practical issues, such as the need to get security-based swap data repositories registered and the reporting rules in place. Access to comprehensive security-based swap data would help the Commission address certain implementation issues. We have discussed these sequencing issues with the CFTC and will continue to do so going forward.

**Q.3. *SEFs.*** Chairman Schapiro, the SEC's proposed rules governing Security-Based SEFs are somewhat different than the CFTC's rules governing SEFs. The CFTC's rule proposals appear to be more pre-

scriptive than required under Dodd-Frank, while the SEC's proposed rules appear to be more consistent with Congressional intent. For example, the definition of SEFs refers to "a trading system or platform in which multiple participants have the ability to execute or trade . . . swaps by accepting bids and offers made by multiple participants" (emphasis added). This would appear to require only that the SEF platform provide the capability for bids and offers to be exposed to multiple participants. Please explain your understanding of the statutory requirements of the SEF definition, and how they informed the SEC's rulemaking.

**A.3.** The Dodd-Frank Act defines, in part, a security-based SEF as "a trading system or platform in which multiple participants have the ability to execute or trade security-based swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce . . . ." The Commission proposed to interpret this statutory language to mean that a security-based SEF must provide its participants with the ability to interact with the trading interest of more than one other participant on the system or platform. The Commission, however, did not propose to interpret this statutory language to require that the security-based SEF's participants actually interact with multiple bids and offers. Therefore, the Commission's proposed interpretation of the definition of "security-based swap execution facility" would enable a participant to send a request for quote to all participants on the system or platform, but also would allow a participant the option to disseminate a request for quote to fewer than all participants. We preliminarily believe that this proposal is consistent with the statutory language, and look forward to reviewing the comments from the public on the proposed interpretation.

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO  
FROM MARY L. SCHAPIRO**

**Q.1.** Are there ways to use technology both to make existing staff more productive and to reduce the number of employees needed for Dodd-Frank responsibilities?

**A.1.** Under the new leadership team in our technology group and our new chief operating officer, we are working on a number of ways to leverage technology rather than necessarily bringing on additional human resources to perform functions that technology does very well.

For example, we are working to deploy knowledge management systems that will allow the sharing of expertise, processes and experience. We are also investing in e-discovery tools that will free up skilled Enforcement staff from intensive paper document review and allow them more time for conducting investigations. We will also continue making investments in systems and technologies needed to facilitate reporting of information required by the Dodd-Frank Act.

In FY2011 we also will be making key investments in general IT infrastructure modernization, including refreshing old technology and system hardware and software to avoid loss of productivity, facilitating the migration of the agency's financial systems to a shared service provider, increasing system capacities to accommo-

date data growth, and increasing operational efficiencies through better monitoring of system performance.

**Q.2.** Has the SEC worked with the CFTC to share information technology developments costs for the oversight of the OTC derivatives market?

**A.2.** The Commission staff has discussed in general terms OTC derivatives market oversight and related systems needs with CFTC staff in the course of our consultation and coordination regarding derivatives rulemaking under Title VII of the Dodd-Frank Act, although these discussions have not addressed the specific costs regarding those systems. The Commission intends to leverage its existing systems, such as the EDGAR filing system, to the extent feasible for its Title VII oversight functions in order to reduce the additional costs imposed by the Commission's new regulatory responsibilities. I note, however, that our budget situation may impact our ability to invest in technology resources for Title VII oversight.

**Q.3.** Your agency and the CFTC have differed quite a bit on several rules with respect to derivatives. Not the least of which is your respective rules for swap execution facilities. I find yours to be much more flexible and appropriate given the uncertainty facing the marketplace. Can you give us an idea as to why you've chosen the route you're taking rather than what the CFTC has proposed?

**A.3.** Since the Dodd-Frank Act was passed last July, the Commission staff has been engaged in ongoing discussions with CFTC staff regarding our respective approaches to implementing the statutory provisions for SEFs and security-based SEFs. In many cases, these discussions have led to a common approach—for example, both proposals have similar registration programs, as well as similar filing processes for rule changes and new products. As you note, however, there are differences in certain areas, such as the treatment of requests for quotes, block trades, and voice brokerage.

Our proposal reflects the Commission's preliminary views as to how the Dodd-Frank Act would best be applied to the trading of security-based swaps, which differ in certain ways from the swaps that will be regulated by the CFTC. We look forward to input from the public as to whether these differences are adequately supported by functional distinctions in the trading and liquidity characteristics of swaps and security-based swaps, as well as comments as to how the agencies' rules may be further harmonized.

**Q.4.** Given the Commission's competing priorities, wouldn't it make sense to draft the SEC's proposal for municipal advisors rule to exclude entities that are already regulated?

**A.4.** As you know, on December 20, 2010, the Commission proposed for public comment rules that would govern the registration of municipal advisors and, among other things, proposed guidance and solicited comment on the appropriate treatment of certain entities that are already regulated, such as brokers, dealers, municipal securities dealers, and investment advisers, in addition to certain professional groups, such as attorneys and engineers.

It is important to note that the statutory framework of the Dodd-Frank Act already excludes many regulated entities from the definition of "municipal advisor" for purposes of their already-regulated

activities. The Dodd-Frank Act provides that the term “municipal advisor” includes a person (who is not a municipal entity or an employee of a municipal entity) that “*provides advice to or on behalf of a municipal entity or obligated person with respect to a municipal financial product or the issuance of municipal securities, including advice with respect to the structure, timing, terms, and other similar matters concerning such financial products or issues or that undertakes a solicitation of a municipal entity*” (emphasis added). In addition, the definition of “municipal advisor” explicitly excludes:

- a “broker, dealer, or municipal securities dealer serving as an underwriter”;
- “any investment adviser registered under the Investment Adviser Act of 1940, or persons associated with such investment advisers who are providing investment advice”;
- “any commodity trading advisor registered under the Commodity Exchange Act or persons associated with a commodity trading advisor who are providing advice related to swaps”;
- “attorneys offering legal advice or providing services that are of a traditional legal nature”; and
- “engineers providing engineering advice”.

Consistent with the statutory requirements, the Commission’s proposed rules would require these regulated entities to register with the Commission only if providing advice or soliciting business that is within the definition of “municipal advisor” and outside of the scope of their regulated activities already excluded by the Dodd-Frank Act.

As part of the proposal, we have also solicited comment on the provision of traditional banking activities within the context of the definition of “investment strategies” and to what extent banks should be excluded from the proposed municipal advisor registration requirements. The staffs of the Commission and the Federal banking regulators are consulting with respect to the appropriate scope of any such exclusion. This consultation should help promote a more effective and efficient implementation of the requirements of the Dodd-Frank Act.

We have received more than 1,000 comment letters on the proposal and we are reviewing them carefully. Public input is critically important in crafting a final rule, and I can assure you that the status of regulated entities will receive very careful consideration before a final rule is adopted.

**Q.5.** I am concerned about the recent SEC proposal on compensation regulation, especially for private fund investment advisers. What will the SEC do to limit the impact of this rule?

**A.5.** The SEC proposal arose out of the requirement in the Dodd-Frank Act that financial regulators jointly develop rules or guidelines governing incentive-based compensation practices at certain financial institutions, including investment advisers as defined in the Investment Advisers Act and registered broker-dealers, with assets of \$1 billion or more. Specifically, the Dodd-Frank Act requires the SEC, the Federal Reserve, OCC, FDIC, OTS, FHFA, and the NCUA, to jointly write rules or guidelines that: (1) require

these “covered financial institutions” to disclose to their appropriate Federal regulator the structure of their incentive-based compensation arrangements so the regulator can determine whether such compensation is excessive or could lead to material financial loss to the firm; and (2) prohibit any type of incentive-based compensation that the regulators determine encourages inappropriate risks by providing excessive compensation or that could lead to material financial loss to the covered firm.

The SEC proposal, as it relates to investment advisers, is limited to investment advisers that have \$1 billion or more in balance sheet assets. The part of the SEC proposal that would require executive officers and certain other designated individuals to defer the receipt of their incentive-based compensation is further limited to investment advisers with \$50 billion or more in balance sheet assets. The proposed rule is the result of SEC staff working closely with other Federal regulators. As with any such undertaking, there is a challenge involved in finding common means to appropriately address Congress’ mandate.

The SEC plans to review carefully the comments that it receives to determine the appropriate method for calculating asset size for private fund investment advisers. More generally, the SEC looks forward to receiving public comment on the proposed rule and specifically on how the practices contemplated by the proposed rule compare to existing conventions. Of particular interest would be commenters’ views on how assets would be calculated for purposes of determining whether institutions meet the \$1 billion and the proposed \$50 billion thresholds, and the proposal’s potential impact on broker dealer and investment adviser business models. As with all of our rulemaking, we will take the comments we receive very seriously and work hard to avoid unintended consequences.

## ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD



NASAA

## NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

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March 9, 2011

The Honorable Tim Johnson  
 Chairman  
 Committee on Banking, Housing, and  
 Urban Affairs  
 Washington, DC 20510

The Honorable Richard Shelby  
 Ranking Member  
 Committee on Banking, Housing, and  
 Urban Affairs  
 Washington, DC 20515

RE: SEC Budget

Dear Chairman Johnson and Ranking Member Shelby:

On behalf of the North American Securities Administrators Association (NASAA),<sup>1</sup> I want to express our support of adequate funding for the Securities and Exchange Commission (SEC) to fully implement its responsibilities mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

Securities regulation is a complementary regime of both state and federal securities laws, and we work closely with our national counterparts to uncover and prosecute violators of those laws. Traditionally, state securities regulators have pursued the perpetrators at the local level who are trying to defraud the "mom and pop" investors in your states. That allows the SEC to focus on the larger, more complex national market manipulation type cases.

While the SEC has been criticized for its past lax enforcement and for not pursuing the Madoff Ponzi scheme earlier, under the leadership of Chairman Mary Schapiro<sup>2</sup> the agency has a renewed determination to return to our joint mission of protecting the public from investment fraud.

We urge Congress to provide the SEC with the resources they need to enhance their technology and take on the examination of investment advisers, hedge funds advisers and credit rating

<sup>1</sup> The oldest international organization devoted to investor protection, the North American Securities Administrators, Inc. was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

<sup>2</sup> Chairman Schapiro previously served as a Commissioner of the SEC from December 1988 to October 1994. She was appointed by President Ronald Reagan in 1988; reappointed by President George H.W. Bush in 1989; named Acting Chairman by President Bill Clinton in 1993; and appointed Chairman of the CFTC by President Clinton in 1994, where she served until 1996.

agencies, which is required under the Dodd-Frank Act. As Chairman Schapiro stated, "the 2012 funding is entirely offset by transactions fees such that the SEC budget will not add to the deficit."

Thank you for your thoughtful consideration of this matter, which is vital to restoring investor confidence and integrity to the marketplace. Please don't hesitate to contact me or NASAA's Director of Policy, Deborah House, if we can be of assistance to you.

Yours,

A handwritten signature in black ink, appearing to read "David S. Massey". The signature is written in a cursive style with a large, sweeping underline that extends to the left and then curves back under the name.

David S. Massey  
North Carolina Deputy Securities Administrator  
NASAA President