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

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

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by

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

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

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

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

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

New Leadership, Organizational Structures, and Expertise

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

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

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

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

Reinvigorating the Enforcement Program

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

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

In addition, we have added a host of measures to encourage corporate insiders and others to come forward with evidence of wrongdoing. These new cooperation initiatives establish incentives for individuals and companies to fully and truthfully cooperate and assist with SEC investigations and enforcement actions, and they provide new tools to help investigators develop first-hand evidence to build the strongest cases as quickly as possible.

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

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

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

Highlights of the initiatives include:

Specialization. The five new national specialized investigative groups dedicated to high-priority areas of enforcement are Asset Management (hedge funds and investment advisers), Market Abuse (large-scale insider trading and market manipulation), Structured and New Products (various derivative products), Foreign Corrupt Practices Act violations, and Municipal Securities and Public Pensions. The specialized units are utilizing enhanced training, specialized industry experience and skills, and targeted investigative approaches to better detect links and patterns suggesting wrongdoing – and ultimately to conduct more efficient and effective investigations. Each of the specialized units is in the process of hiring additional professionals with specialized experience to assist in investigative and enforcement efforts.

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

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

investigations. While a layer of management has been eliminated, the Division is maintaining staff-to-manager ratios that allow for close substantive consultation and collaboration, resulting in a management structure that facilitates timeliness, quality, and staff development. The Division also has hired its first-ever Managing Executive, who is creating a business management network throughout the Division that is focused on the Division's administrative, operational, and infrastructure functions, thus freeing up valuable investigative resources for mission-critical work.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Strengthening Examinations and Oversight

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

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

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

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

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

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

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

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

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

Improving the Audit Follow-Up Process

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

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

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

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

Actions Taken in the Wake of the May 6 Market Disruption

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Improving Agency Systems and Management

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

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

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

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

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

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

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

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

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

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

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

Engaging in a Significant Investor-Focused Rulemaking Agenda

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

Adopted:

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

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

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

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

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

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

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

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

Proposed:

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

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

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

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

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

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

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

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

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

SEC Resources

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

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

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

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

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

Managing Agency Growth

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

Oversight of the PCAOB and FINRA

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

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

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

Oversight of SIPC

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

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

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

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

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

Coordination and Cooperation with State Securities Regulators

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

Implementation Challenges of Regulatory Reform Legislation

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

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

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

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

Conclusion

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

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

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