Testimony on "Management and Structural Reforms at the SEC: A Progress Report"

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U.S. Securities and Exchange Commission

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Subcommittee on Securities, Insurance, and Investment

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Chairman Reed, Ranking Member Crapo, Members of the Subcommittee:

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

As Directors of six major divisions and offices of the SEC, each of us came to the agency within the past three years dedicated to furthering the Commission's vital mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation. We appreciate the opportunity to discuss the broad responsibilities performed by the SEC, the recent reforms we have undertaken, and the challenges that lie ahead.

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

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

Current Challenges

FY 2012 will be a critical period for the SEC. Not only does the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") create significant additional mandates for the SEC, both in the short and long term, but the agency must continue to carry out its longstanding core responsibilities. These responsibilities — pursuing securities fraud, reviewing public company disclosures and financial statements, inspecting the activities of investment advisers, investment companies, broker-dealers and other registered entities, and maintaining fair and efficient markets — remain essential ingredients to restoring investor confidence and trust in financial institutions and markets following the recent financial crisis.

Over the past decade, the SEC has faced significant challenges in maintaining a staffing level and budget sufficient to carry out its core mission. The SEC experienced three years of frozen or reduced budgets from FY 2005 to 2007 that forced a reduction of 10 percent of the agency's staff. Similarly, after significant increases in technology spending from FY 2002 to FY 2005 the agency's investments in new or enhanced IT systems declined about 50 percent from FY 2005 to 2009.

As a result of increased funding levels in FY 2009 and FY 2010, current SEC staffing levels are just returning to the level of FY 2005, despite the enormous growth in the size and complexity of the securities markets since then. During the past decade, for example, trading volume has more than doubled, the number of investment advisers has grown by 50 percent, and the assets they manage have increased to $43 trillion. A number of financial firms spend many times more each year on their technology budgets alone than the SEC spends on all of its operations. Six years ago, the level of SEC funding was sufficient to provide 19 examiners for each trillion dollars in assets under management by investment advisers. Today, that figure stands at 12 examiners per trillion dollars.

Today, the SEC has responsibility for approximately 35,000 entities, including oversight of 11,700 investment advisers, 9,500 mutual funds and ETFs and close to 5,000 broker-dealers with more than 160,000 branch offices. We also review the disclosures and financial statements of nearly 10,000 reporting companies. The SEC also oversees approximately 500 transfer agents, 15 national securities exchanges, 8 active clearing agencies, and several nationally recognized statistical ratings organizations (NRSROs), as well as the Public Company Accounting Oversight Board (PCAOB), Financial Industry Regulatory Authority (FINRA), Municipal Securities Rulemaking Board (MSRB), and the Securities Investor Protection Corporation (SIPC). In addition, the Enforcement Division has jurisdiction over any person or entity that violates the securities laws, regardless of whether they are associated with one of these 35,000 entities.

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

In acknowledgement of this significant new workload, the Dodd-Frank Act authorized a significant increase in the agency's budget authority over the next several years. So far, the SEC has proceeded with the first stages of implementation of the Dodd-Frank Act without additional funding as appropriations have not matched the increased budget authority. This implementation activity largely has involved performing studies, analyses, and writing rules. These initial tasks have taken staff time away from other critical responsibilities, as we have carried them out almost entirely with existing staff. It is the next step of making the new oversight regimes operational that will require significant additional resources.

This resource gap was highlighted in a report prepared by the Boston Consulting Group (BCG) pursuant to Section 967 of the Dodd-Frank Act that directed the agency to engage the services of an independent consultant to study a number of specific areas of SEC operations. In addition to highlighting this resource gap, the BCG study is providing an opportunity to re-examine and improve the SEC's operations. The Commission staff is conducting a thorough analysis of each recommendation and designing appropriate approaches for those recommendations selected for implementation.

Notwithstanding these challenges, the Commission remains committed to serving the public in satisfying our three-part mission. To this end, it is incumbent upon us to use our existing resources as efficiently as we can. Simply put, as we protect investors, we have an obligation to be good stewards of the resources that are or may be allotted to us.

DIVISION OF ENFORCEMENT

Director, Robert Khuzami[1]

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

Structural Reforms

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

Specialization. The introduction of five new national specialized investigative units dedicated to high-priority areas of enforcement which consist of: Asset Management (hedge

[1] Mr. Khuzami joined the SEC as Director of Enforcement in March 2009. http://www.sec.gov/news/press/2009/2009-31.htm

funds and investment advisers), Market Abuse (high-volume and computer-driven trading strategies, large-scale insider trading, and market manipulation schemes), Structured and New Products (various derivative products), Foreign Corrupt Practices Act violations, and Municipal Securities and Public Pensions. The specialized units, as well as various specialization initiatives in our regional offices, are utilizing enhanced training, specialized industry experience and skills, and targeted investigative approaches to better detect links and patterns suggesting wrongdoing — and ultimately to conduct more efficient and effective investigations. In addition to investigative work, the specialized units are engaged in a number of initiatives with our colleagues in the Office of Compliance Inspections and Examinations (OCIE) and other divisions to develop risk analytics that proactively identify high-risk areas for further examination and investigation.

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

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

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

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

Streamlining Process. We improved our law enforcement capabilities and sent a clear signal internally and externally that we value toughness and speed. For example, the Commission delegated to senior staff the authority to initiate formal investigations and issue subpoenas without the prior approval of the Commission. We also have eliminated approvals for certain routine settlement discussions, Wells notices and the opening of initial matters under investigation. Proper levels of supervision and oversight remain across all of these areas.

Whistleblower Office. The Dodd-Frank Act substantially expands the agency's authority to compensate individuals who provide the SEC with useful information about violations of the federal securities laws. Last November, the Commission proposed rules mapping out the procedure for would-be whistleblowers to provide critical information to the agency. The Commission adopted final rules in May, which became effective on August 12, 2011. The final rules set forth how eligible whistleblowers must submit their tips to be eligible for an award, the process to apply for an award, and sets forth eligibility criteria and applicable definitions. The Office of the Whistleblower is currently staffed with six attorneys and a senior paralegal and is actively recruiting a Deputy Chief. Staff in the Office of the Whistleblower are communicating with whistleblowers and their counsel, conducting internal and external training sessions and working with enforcement staff on documenting whistleblowers' ongoing contributions to current investigations. The Commission also has fully funded from monetary sanctions collected in enforcement actions, the SEC Investor Protection Fund, which will be used to pay awards to qualifying whistleblowers.

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

Effective Results

Record Number of Enforcement Actions Filed. Although statistics alone cannot capture the breadth of the Division's work, since undertaking these reforms, the SEC's enforcement activity has increased significantly, resulting in substantial benefits for markets and investors. In recently-ended fiscal year 2011, the first complete fiscal year since the Division's reorganization, the SEC filed 735 enforcement actions – more enforcement actions than ever filed in a single year in SEC history. Those enforcement actions resulted in more than $2.8 billion in penalties and disgorgement ordered in fiscal year 2011. In fact, in each of the past three fiscal years, we have filed more enforcement actions than in the previous fiscal year.

Financial Crisis Cases. During the last two-and-a-half years, the agency has filed 36 separate actions in its financial crisis-related cases against 81 defendants – nearly half of whom were CEOs, CFOs and senior corporate executives, resulting in approximately $1.97 billion in disgorgement, penalties, and other monetary relief obtained. This includes enforcement actions against Goldman Sachs and Citigroup, as well as senior executives from Countrywide Financial, New Century and American Home Mortgage. In FY 2011, the SEC filed 15 separate financial-crisis-related actions naming 17 individuals, including 16 CEOs, CFOs and other senior corporate officers, involving wrongdoing related to the financial crisis. These cases include enforcement actions involving collateralized debt obligations (CDOs) charging J.P. Morgan with misleading investors in a CDO as the housing market began to plummet, Wachovia Capital Markets with misconduct in the sale of two CDOs tied to the performance of residential mortgage-backed securities, and two firms (Stifel, Nicolaus & Co. and RBC Capital Markets) with misconduct in the sale of unsuitable CDO investments to five Wisconsin school districts. The SEC also charged six executives at Brooke Corporation and three executives at mortgage lender IndyMac Bancorp for misleading investors about the deteriorating financial condition at their respective companies. Separately, Morgan Keegan & Company this year paid $200 million to settle charges brought in fiscal year 2010 that it falsely valued subprime mortgage securities in five funds managed by an affiliate, with the controller and portfolio manager also charged.

Insider Trading Cases. The Division's focus on insider trading cases has resulted in enhanced enforcement, with 57 actions filed in fiscal year 2011 by the SEC – a nearly 8 percent increase over last year's total. Among those charged in SEC insider trading cases in the past fiscal year were various hedge funds managers and traders involved in a $30 million expert networking trading scheme, a former NASDAQ Managing Director, a former Major League Baseball player and an FDA chemist. The SEC also brought insider trading charges against a Goldman Sachs employee and his father who traded on confidential information learned at work on the firm's ETF desk, and a corporate board member of a major energy company and his son for trading on confidential information about the impending takeover of the company. In fiscal year 2011, the SEC obtained judgments in 18 actions arising out of its investigation of hedge fund manager Raj Rajaratnam, the founder of Galleon Management, who was recently convicted of multiple counts of insider trading. Just last week, the SEC obtained a record financial penalty of $92.8 million in its civil action against Rajaratnam. In addition, the SEC provided significant assistance to the U.S. Attorney's Office for the Southern District of New York in its successful criminal prosecution of Rajaratnam.

Financial Fraud and Issuer Disclosure Cases. The SEC brought 89 actions in fiscal year 2011 charging financial fraud and issuer disclosure violations. Those cases included actions charging Satyam Computer Services Limited with fraudulently overstating its financial results by more than $1 billion over five years, the India-based affiliates of PricewaterhouseCoopers for their audit failures related to Satyam, and DHB Industries, Inc., a major supplier of body armor to the U.S. military and law enforcement agencies, for engaging in a massive accounting fraud. The SEC also filed separate fraud charges against DHB's former outside directors and audit committee members charging them with facilitating the company's fraud.

Investment Adviser and Broker-Dealer Cases. The agency filed a total of 146 enforcement actions related to investment advisers and investment companies, a single-year record and 30 percent increase over fiscal year 2010. The SEC also brought 112 enforcement actions related to broker-dealers in fiscal year 2011, a 60 percent increase over last fiscal year. Among those charged in SEC investment adviser and broker dealer actions in the past fiscal year were Charles Schwab entities and executives for making misleading statements to investors regarding a mutual fund heavily invested in mortgage-backed and other risky securities, AXA Rosenberg Group LLC and its founder for concealing a significant error in the computer code of the quantitative investment model that they used to manage client assets, and Merrill Lynch, Pierce, Fenner & Smith for misusing customer order information to place proprietary trades for the firm and for charging customers undisclosed trading fees. The Schwab entities paid more than $118 million to settle the SEC's charges, while AXA Rosenberg paid $217 million to cover investor losses and a $25 million penalty.

Cases Arising from Cross Border Working Group. The work of the SEC's Cross Border Working Group, a proactive risk-based initiative focusing on U.S. companies with substantial foreign operations, led to numerous important enforcement actions in fiscal year 2011. This included the first-ever stop orders for post-effective registration statements due to the resignation of a company's independent auditor and multiple trading suspensions of China-based U.S. securities because of concerns over the accuracy and completeness of their publicly filed information.

Cases Targeting Vulnerable Investors. The SEC also brought actions against individuals and firms charging them with targeting vulnerable investors in fiscal year 2011, such as cases charging the three senior executives at Fair Finance Company with orchestrating a $230 million fraudulent scheme involving thousands of investors, many of them elderly, and the internet-based investment company Imperia Invest IBC with operating a scheme targeting many members of the deaf community.

Finally, the following sample of cases filed by the Enforcement Division in one seven-day period in October 2011 reveals both the complexity and the diversity of the markets, practices, and products that we police, as well as the depth of expertise needed to do our job effectively:

- Failure to disclose to investors that a firm structuring and marketing a $1 billion collateralized debt obligation also exercised significant influence over the selection of $500 million of the assets included in the CDO and took a proprietary short position concerning those $500 million of assets during a time when the U.S. housing market was showing signs of distress. (*SEC v. Citigroup Global Markets and Brian H. Stoker*, filed October 19, 2011);
- Misleading representations to customers of a "dark pool" trading platform that customers' interests in trading large amounts of stock would be anonymously matched while failing to disclose that the overwhelming majority of the shares traded on its dark pool platform were in fact bought or sold by a wholly owned subsidiary of Pipeline. (*SEC v. Pipeline Trading System LLC, Fred Federspeil and Alfred R. Berkeley III*, filed October 24, 2011);
- Insider trading by a then-director of both Goldman Sachs and Procter & Gamble who provided confidential Board information about both companies' quarterly earnings and about an impending $5 billion Berkshire Hathway investment in Goldman Sachs to Raj Rajaratnam, the now-convicted founder of the Galleon hedge fund, who traded on that information. (*SEC v. Rajat K. Gupta and Raj Rajaratnam*, filed October 26, 2011); and
- Misleading statements to prospective investors by an investment advisory firm and its principal concerning the principal's education, work experience, and the fund's auditor,

prime broker/custodian, and corporate status when soliciting individuals to invest in their purported quantitative hedge fund while at the same time diverting investor money to the principal's personal bank account. (*SEC v. Locust Offshore Management and Andrey C. Hicks,* temporary restraining order and asset freeze filed October 26, 2011).

Upcoming Challenges

Two overarching principles drive the Division's enforcement program. First, we need to stop fraud and misconduct as early as possible, before investor losses have mounted, evidence becomes stale, perpetrators have vanished, and the opportunities to partner with our criminal law enforcement colleagues to employ undercover and other proactive investigative techniques have been lost. Second, we must be an effective enforcement and deterrent force in complex markets and with regard to opaque and complicated products and transactions. This can be accomplished through increased expertise, recruitment and retention of high-quality legal talent, and expanded use of market data and other quantitative analytics. As shown above, the Division's record fiscal year 2011 achievements in both the quality and quantity of cases reflect that we are achieving both of these visions – an accomplishment all the more noteworthy given that it occurred side-by-side with implementation of the biggest restructuring in the history of the Division.

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

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

CORPORATION FINANCE

Director, Meredith Cross[2]

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

Generally, CF reviews company filings, makes rulemaking recommendations to the Commission, and provides interpretive advice to market participants and the public about the securities laws and corresponding regulations. During FY 2011, the Division established three new offices – the Office of Structured Finance, which focuses on disclosure reviews and policy-making for asset-backed securities and other structured products; the Office of Capital Markets Trends, which evaluates trends in securities offerings and in our capital markets to determine whether our rules, regulations, and review approach are adequately addressing them; and a new review group in disclosure operations, which focuses on the largest financial institutions. In light of budget constraints, the Division staffed these offices almost entirely by transferring existing staff to them. If resources permit, the Division plans to add resources to these offices to fully staff them to enable them to carry out their intended work.

Review of Filings

CF selectively reviews filings of new issuers and public companies reporting under the 1934 Act to both monitor and enhance compliance with disclosure and accounting requirements. The particular filings reviewed are selected based on the Division's non-public selective review criteria. The staff members engaged in filing reviews have accounting and disclosure expertise aligned with the industries in their respective review groups. Approximately 80 percent of the staff of the Division is assigned to the disclosure review program.

The Sarbanes-Oxley Act requires the Commission to review disclosures made by companies reporting under the 1934 Act at least once every three years and more frequently where circumstances warrant. Under Sarbanes-Oxley, this review is required to include the company's financial statements. In fulfilling its missions, the staff reviews the disclosure of many companies more often than once every three years. For example, the largest companies that represent the most risk to investors are reviewed more often and the largest financial institutions currently are reviewed continuously on a real-time basis. CF also selectively reviews registration statements and other filings made under the 1933 Act and the 1934 Act relating to capital raising transactions or business combinations. For example, the staff in CF has also allocated its resources to the review of 1934 Act filings made in connection with reverse mergers.

In the course of a review, the staff will issue comments to a company to elicit better compliance with applicable disclosure requirements. In response to those comments, a company may need to amend its financial statements or other disclosures to provide additional or enhanced

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[2] Ms. Cross joined the SEC as Director of Corporation Finance in June 2009. http://www.sec.gov/news/press/2009/2009-78.htm

information, or may undertake to improve its disclosures in future filings. Where appropriate, CF refers matters to the Division of Enforcement.

CF is in the process of enhancing its disclosure review program, including by increasing its focus on large and financially significant registrants The increased focus on these companies requires greater resources than traditional disclosure reviews, and the ability to implement these enhancements turns on whether we are able to allocate sufficient resources, balancing all other demands on the Division and its limited staff.

Smaller reporting companies – generally, those with a public float less than $75 million – comprise over half of the public companies filing with the SEC, yet their aggregate market capitalization is less than one percent of the total market capitalization of all reporting companies that the Division reviews. While these companies, and investors making decisions about them, may particularly benefit from detailed SEC staff review, in light of resource constraints and the small market capitalization of these issuers, the Division is in the process of recalibrating its reviews of smaller companies to gain efficiencies, while still satisfying the Sarbanes-Oxley Act mandate to review the financial statements of all public companies at least once every three years.

Interpretive Advice

CF provides advice to market participants and the public through interpretive releases, staff legal and accounting bulletins, updates to the Division's financial reporting manual, no-action and interpretive letters, issuance of compliance and disclosure interpretations and staff disclosure guidance topics on the Commission's website, and responses to telephone and e-mail inquiries. As the Commission implements the remaining rules required under the Dodd Frank Act, CF expects there to be an increase in workload in requests for interpretive advice.

Rulewriting

CF also recommends new rules or changes to existing rules to the Commission as needed to improve investor protection through enhanced disclosure requirements and to facilitate capital formation. CF's recent rulewriting activities have focused on asset-backed securities, proxy disclosure and voting, and Dodd-Frank Act implementation. Most recently, CF has commenced a significant project designed to facilitate capital formation by reviewing and if consistent with investor protection, recommending changes to current offering rules. These efforts, which have been largely staffed using existing resources, are described briefly below.

<u>Capital Formation Matters</u>. The Division is currently reviewing some of the current offering rules to develop ideas for the Commission to consider that may reduce the regulatory burdens for capital formation, including for small business, in a manner consistent with investor protection. These include:

- **The number of shareholders and other triggers for public reporting.** The staff is reviewing the triggers for public reporting and the characteristics of companies that should be subject to public reporting obligations. To facilitate the Commission's review of the issues related to the thresholds for public reporting (and those for leaving the reporting system), the staff is undertaking a robust study much like the one conducted when Section 12(g) was enacted. The study is seeking to determine whether the current thresholds and standards effectively implement the 1934 Act registration and reporting requirements and what it means to be a "public" company such that an issuer should be required to register its securities and file with the Commission. The staff has begun a detailed analysis of public company information – including numbers of record and beneficial owners, total assets, and public float – to assess the characteristics of public companies. The study also will seek to obtain and consider private company information to assess current reporting thresholds.

- **The restriction on general solicitation in private offerings.** CF staff is also reviewing the restrictions the Commission's rules impose on communications in private offerings, in particular the restrictions on general solicitation. In analyzing whether to recommend changes to the restriction, the staff is considering next steps, and is preparing a concept release for the Commission's consideration, through which it could seek the public's input on the advisability and the costs and benefits of retaining or relaxing the restrictions on general solicitation.

- **Restrictions on communications in public offerings.** The Division's staff is also assessing the Commission's rules, and the regulatory burdens they impose, with respect to communications in public offerings. The staff is reviewing the rules to consider whether any of the liberalizations adopted in 2005[3] for the largest issuers should be adapted for smaller public companies, including whether more companies should be able to use free writing prospectuses before a substantially complete prospectus is filed. As a result of this review, Division staff may recommend proposed changes to the offering rules, or recommend that the Commission seek additional input through the issuance of a concept release.

Additional areas CF staff is reviewing with respect to capital formation concern the regulatory questions posed by new capital raising strategies, such as crowdfunding, and the scope of the Commission's existing rules that provide for capital raising, such as Regulation A.

In connection with these projects, the Division will consider recommendations of the recently-formed SEC Advisory Committee on Small and Emerging Companies and the Government Business Forum on Small Business Capital Formation, as well as ideas from other sources in developing recommendations for the Commission's consideration to facilitate small business capital formation, consistent with investor protection.

<u>Improvements to proxy voting and shareholder communications processes.</u> The Commission received significant public comment on its concept release regarding proxy voting and shareholder communications.[4] CF staff is working closely with other SEC divisions and offices with regard to possible recommendations to the Commission for proposed rule amendments or other Commission action to address areas that may be in need of improvement.

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[3] *See* Release No. 33-8591, *Securities Offering Reform* (July 19, 2005), http://www.sec.gov/rules/final/33-8591.pdf.
[4] *See* Release No. 34-62495, *Concept Release on the U.S. Proxy System* (July 14, 2010), http://www.sec.gov/rules/concept/2010/34-62495.pdf.

Asset-backed securities. The Division is preparing recommendations for the Commission to consider adopting several ABS rules, following rule proposals in April 2010 and a reproposal in July 2011. In April 2010, the Commission proposed significant revisions to the disclosure, reporting and offering process for asset-backed securities.[5] In July 2011, the Commission re-proposed some of the proposals from April 2010, including the proposals relating to the shelf eligibility requirements for ABS, and requested comment on other aspects of the April 2010 proposal.[6] The comment period for the July 2011 release ended on October 4, 2011.

Dodd-Frank Rules. In addition to the rulemaking initiatives discussed above, CF staff is responsible for preparing recommendations for the Commission to adopt rules to implement a significant number of Dodd-Frank Act requirements. CF reassigned a number of attorneys from throughout the Division, including disclosure operations, to work on these rulemaking projects. CF completed several projects mandated by the Dodd-Frank Act during FY 2011, and expects to present the Commission with recommendations to complete the remaining rulemaking projects during FY 2012.

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

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

- **Representations and Warranties.** On January 20, 2011, the Commission adopted final rules to implement Section 943 of the Dodd-Frank Act, which requires the Commission to adopt rules regarding representations and warranties in ABS.[7]

- **Issuer Review of Underlying Assets.** On January 20, 2011, the Commission adopted final rules to implement Section 945 of the Dodd-Frank Act.[8] Section 945 requires the Commission to issue rules requiring an asset-backed issuer in a 1933 Act registered transaction to perform a review of the assets underlying the ABS, and disclose the nature of such review.

- **Risk Retention.** On March 30, 2011, the Commission joined fellow financial regulators in issuing for public comment proposed risk retention rules to implement Section 941 of

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[5] *See* Release No. 33-9117, *Asset-Backed Securities* (April 7, 2010), http://www.sec.gov/rules/proposed/2010/33-9117.pdf.

[6] *See* Release No. 33-9244, *Re-proposal of Shelf Eligibility Conditions for Asset-Backed Securities and Other Additional Requests for Comment* (July 26, 2011), http://www.sec.gov/rules/proposed/2011/33-9244.pdf.

[7] *See* Release No. 33-9175, *Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (January 20, 2011), http://www.sec.gov/rules/final/2011/33-9175.pdf.

[8] *See* Release No. 33-9176, *Issuer Review of Assets in Offerings of Asset-Backed Securities* (January 20, 2011), http://www.sec.gov/rules/final/2011/33-9176.pdf.

the Dodd-Frank Act.[9] The proposed rules address the appropriate amount, form, and duration of required risk retention for ABS securitizers, and the definition of qualified residential mortgages. Although the original comment period was scheduled to close on June 10, 2011, in light of requests from various sources for an extension to allow sufficient time for data gathering and impact analyses related to the provisions of the proposed rule, the Commission extended the comment period to August 1, 2011. The Commission staff, together with staff from the other regulators, is carefully considering the issues and concerns raised in the comments received as it prepares recommendations for the Commission for final rules.

- In August 2011**,** the Commission adopted rules in connection with Section 942(a) of the Dodd-Frank Act, which eliminated the automatic suspension of the duty to file reports under Section 15(d) of the 1934 Act for ABS issuers and granted the Commission authority to issue rules providing for the suspension or termination of this duty to file reports. The new rules permit suspension of the reporting obligations for ABS issuers when there are no longer asset-backed securities of the class sold in a registered transaction held by non-affiliates of the depositor.[10]

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

- **"Say-on-Pay" and "Golden Parachute."** In January 2011, the Commission adopted rules to implement the provisions of the Dodd-Frank Act that require public companies subject to the federal proxy rules to provide their shareholders with:
    - an advisory vote on executive compensation, generally known as "say-on-pay" votes, as well as with an advisory vote on the desired frequency of say-on-pay votes.
    - an advisory vote on compensation arrangements and understandings in connection with merger transactions, known as "golden parachute" arrangements.

- **Compensation Committees and Compensation Consultants**. The Commission is required by Section 952 of the Dodd-Frank Act to mandate new listing standards relating to the independence of compensation committees and to establish new disclosure requirements and conflict of interest standards that boards must observe when retaining compensation consultants. In March 2011, the Commission issued a proposal to implement Section 952.[11] The comment period for the proposal ended on May 19, 2011, and the staff is currently developing recommendations for final rules.

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[9] *See* Release No. 34-64148, *Credit Risk Retention* (March 30, 2011), http://www.sec.gov/rules/proposed/2011/34-64148.pdf.

[10] See Release No. 34-65148, *Suspension of the Duty to File Reports for Classes of Asset-Backed Securities under Section 15(d) of the Securities Exchange Act of 1934* (August 17, 2011), http://www.sec.gov/rules/final/2011/34-65148.pdf.

[11] *See* Release No. 33-9199, *Listing Standards for Compensation Committees* (March 30, 2011), http://www.sec.gov/rules/proposed/2011/33-9199.pdf.

In addition, CF staff is working on developing recommendations for the Commission concerning the implementation of the following provisions of the Dodd-Frank Act:

- **Recovery of Erroneously Awarded Compensation.** Section 954 of the Dodd-Frank Act requires the Commission to adopt rules mandating new listing standards relating to specified executive compensation “clawback” policies.

- **Pay versus Performance and Pay Ratios**. Under Section 953 of the Dodd-Frank Act, the Commission must adopt rules requiring new disclosures about the relationship between executive compensation and company performance, and the ratio between the median of the annual total compensation of an issuer’s employees and the annual total compensation of the issuer’s chief executive officer.

- **Employee and Director Hedging**. Section 955 of the Dodd-Frank Act requires the Commission to adopt rules requiring disclosure by issuers of their policies relating to certain employee and director hedging activities.

Specialized Disclosures. Title XV of the Dodd-Frank Act contains specialized disclosure provisions related to conflict minerals, coal or other mine safety, and payments by resource extraction issuers to foreign or U.S. government entities. The Commission published the rule proposals relating to these three provisions in December 2010[12] and the comment period ended on March 2, 2011. The Commission recently held a public roundtable regarding the conflict minerals rulemaking, and reopened the comment period from October 6, 2011 until November 1, 2011 in connection with the roundtable. The staff is preparing final rule recommendations for the Commission on these three rulemakings.

Exempt Offerings.

- **Accredited Investor.** Section 413(a) of the Dodd-Frank Act requires the definition of “accredited investor” in the Commission’s 1933 Act rules to exclude the value of a person’s primary residence for purposes of determining accredited investor status on the basis of having net worth in excess of $1 million. The Commission proposed rule amendments on January 25, 2011 that would implement this provision, and would clarify the treatment of any indebtedness secured by the residence in the net worth calculation.[13] The comment period on this proposal ended on March 11, 2011 and the staff is preparing final rule recommendations for the Commission.

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[12] *See* Release No. 34-63547, *Conflict Minerals* (December 15, 2010), http://www.sec.gov/rules/proposed/2010/34-63547.pdf; Release No. 33-9164, *Mine Safety Disclosure* (December 15, 2010), http://www.sec.gov/rules/proposed/2010/33-9164.pdf, Release No. 34-63549, *Disclosure of Payments by Resource Extraction Issuers* (December 15, 2010), http://www.sec.gov/rules/proposed/2010/34-63549.pdf.

[13] *See* Release No. 33-9177, *Net Worth Standard for Accredited Investors* (January 25, 2011), http://www.sec.gov/rules/proposed/2011/33-9177.pdf.

- **"Felons and Other 'Bad Actors'".** Under Section 926 of the Act, the Commission is required to adopt rules that disqualify securities offerings involving certain "felons and other 'bad actors'" from relying on the safe harbor from 1933 Act registration provided by Rule 506 of Regulation D. The Commission proposed rules to implement the requirements of Section 926 on May 25, 2011,[14] and the comment period for this rule proposal ended on July 14, 2011. The staff is preparing final rule recommendations for the Commission.

Credit Rating Agencies. The Dodd-Frank Act resulted in several rulemakings related to nationally recognized statistical rating organizations. In July 2011, the Commission adopted rule amendments removing credit ratings as conditions for companies seeking to use short-form registration when registering non-convertible securities for public sale. Under the new rules, the test for eligibility to use Form S-3 or Form F-3 short-form registration is tied to the amount of debt and other non-convertible securities (other than equity) a particular company has sold in registered primary offerings within the previous three years, or that the company has outstanding that were issued in registered primary offerings.[15] In addition, in September 2010, as required by Section 939B of the Dodd-Frank Act, the Commission adopted a rule amendment to remove communications with credit rating agencies from the list of excepted communications in Regulation FD.[16]

Security-Based Swaps. CF has responsibility for certain rulemakings related to Title VII of the Dodd-Frank Act, which imposed a new regime for the regulation of OTC derivatives. This includes proposed exemptions under the 1933 Act, the 1934 Act, and the Trust Indenture Act of 1939 for security-based swaps transactions involving certain clearing agencies satisfying certain conditions, in order to facilitate clearing of security-based swaps,[17] interim exemptions from certain provisions of the federal securities laws that would otherwise have applied to security-based swaps on July 16, 2011,[18] and extension of certain existing temporary rules and relief to continue to facilitate the clearing of certain credit default swaps by clearing agencies functioning as central counterparties.[19] The Commission also readopted certain beneficial ownership rules to preserve their application to persons who purchase or sell security-based swaps.[20]

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[14] *See* Release No. 33-9211, *Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings* (May 25, 2011), http://www.sec.gov/rules/proposed/2011/33-9211.pdf.

[15] *See* Release No. 33-9245, *Security Ratings* (July 27, 2011), http://www.sec.gov/rules/final/2011/33-9245.pdf.

[16] *See* Release No. 33-9146, *Removal from Regulation FD of the Exemption for Credit Rating Agencies* (September 29, 2010), http://www.sec.gov/rules/final/2010/33-9146.pdf.

[17] *See* Release No. 33-9222, *Exemptions for Security-Based Swaps Issued by Certain Clearing Agencies* (June 9, 2011), http://www.sec.gov/rules/proposed/2011/33-9222.pdf.

[18] *See* Release No. 33-9231, *Exemptions for Security-Based Swaps*, (July 1, 2011), http://www.sec.gov/rules/interim/2011/33-9231.pdf.

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[19] *See* Release No. 33-9232, *Extension of Temporary Exemptions for Eligible Credit Default Swaps to Facilitate Operation of Central Counterparties to Clear and Settle Credit Default Swaps* (July 1, 2011), http://www.sec.gov/rules/interim/2011/33-9232.pdf.

Enforcement Liaison
The Division regularly provides technical assistance to the Division of Enforcement on enforcement matters. In the 2011 fiscal year, CF responded to close to 2,000 inquiries from that Division, and referred more than 400 matters to Enforcement. In the first month of the 2012 fiscal year, CF referred more than 50 matters to Enforcement.

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

Upcoming Challenges

While CF has developed review practices and procedures to satisfy the Sarbanes-Oxley Act review mandate,limited resources constrain the Division's ability to devote sufficient resources to the review of companies that represent the largest portion of U.S. market capitalization. The Division's limited staff is responsible for reviewing the disclosures of nearly 10,000 reporting companies under this review mandate, and also for selectively reviewing registration statements and other transactional filings made under the 1933 Act and 1934 Act, such as filings related to capital raising and business combinations. The challenges of staffing the review program are even greater in light of the Division's new responsibilities under the Dodd-Frank Act. As noted, CF is currently implementing changes to its review program with the goal of increasing its focus on large and financially significant registrants and recalibrating its reviews of smaller reporting companies in order to gain additional efficiencies, in a manner consistent with its obligations under the Sarbanes-Oxley Act. CF has also made targeted changes to its operations, including the formation of three new offices in order to better fulfill our mission of investor protection. The ability to realize these benefits will be compromised, however, if we are unable to fully staff them and/or are unable to hire additional staff to enhance our expertise in these areas.

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[20] *See* Release No. 34-64628, *Beneficial Ownership Reporting Requirements and Security-Based Swaps* (June 8, 2011), http://www.sec.gov/rules/final/2011/34-64628.pdf.

TRADING AND MARKETS

Director, Robert Cook[21]

The Division of Trading and Markets (TM) is responsible for establishing and maintaining standards for fair, orderly, and efficient markets. TM's workload is dominated by a diverse range of core functions that are vital for protecting investors and markets, and the scope of many of these functions expanded significantly under the Dodd-Frank Act. In addition, TM has taken on substantial new responsibilities as a result of the Dodd-Frank Act, in particular the implementation of a new regulatory regime governing certain over-the-counter (OTC) derivatives.

TM's Core Functions

Regulation for Securities Markets

TM devotes substantial resources to developing and maintaining appropriate regulations for the securities markets, including 15 securities exchanges (equities and options), 3 electronic communication networks (ECNs), over 60 active alternative trading systems, and over 200 internalizing broker-dealers. TM's ongoing responsibilities include:

- Reviewing new exchange registrations, an extensive process that requires analysis of, among other complex issues, the impact of a new exchange on the protection of investors, the public interest, and the national market system.

- Processing proposed SRO rule changes, which address issues ranging from new fee structures to changes in trading rules to revamped governance structures. As of last month, TM had received over 1,800 rule filings this calendar year, and we anticipate receiving over 350 more before the end of the year.[22] These filings are reviewed for consistency with the Exchange Act, including requirements for fair and orderly markets and for limiting burdens on competition. The Dodd-Frank Act imposed new procedural requirements with respect to the Commission's processing of these filings, which substantially increased TM's workload.

- Reviewing new financial products, ranging from now-common index exchange traded funds (ETFs) to physical commodity trusts to more esoteric products.

- Initiating changes to market rules to keep apace with market developments.

Over the past few years, TM has focused on several key initiatives to improve the oversight and function of our markets:

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

22 This number includes filings by the exchanges and other SROs, such as clearing agencies, FINRA, and the MSRB.

- *Sponsored Access*. In November 2010, the Commission took an important step to promote market stability by adopting a new market access rule.[23] Broker-dealers that access the markets themselves or offer market access to customers will be required to put in place appropriate pre-trade 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 help prevent broker-dealers or their customers from engaging in practices that could increase risks to the financial condition of other market participants and clearing organizations, as well as the integrity of trading on the securities markets.

- *Large Trader Reporting*. In July 2011, the Commission adopted new rules to help identify, and obtain trading information on, market participants that conduct a substantial amount of trading activity in the U.S. securities markets.[24] These new large trader reporting requirements are designed to provide the Commission with a valuable source of useful data to support: (1) its investigative and enforcement efforts; (2) reconstruction of trading activity following significant market events; and (3) analysis of the impact of large traders on the securities markets.

- *Consolidated Audit Trail*. TM is preparing recommendations for the Commission's consideration for a final rule to create, implement, and maintain a consolidated audit trail, another of the Commission's proposals to address significant shortcomings in the agency's present ability to collect and monitor trade data in an efficient and scalable manner.[25] If implemented, the consolidated audit trail would, for the first time, allow SROs and the Commission to track trade data across multiple markets, products and participants simultaneously. It would also boost regulators ability to rapidly reconstruct trading activity and to more quickly analyze both suspicious trading and unusual market events. The Commission received many informative comments on the proposed rule, which TM is taking into account in preparing its recommendations – including discussion of the benefits of a consolidated audit trail, feedback addressing the estimated cost of implementing a consolidated audit trail and proposals for possible alternatives for achieving the Commission's goals.

- *Additional Steps to Address the Events of May 6, 2010*. TM leads the Commission's efforts to monitor and respond to significant market events, such as the severe market disruption of May 6, 2010. In addition to spearheading the Commission's inquiry into that day's events, coordinating an independent joint SEC-CFTC advisory committee focusing on those events, and publishing two joint reports with the staff of the CFTC, TM recommended implementation of key regulatory responses, including: (1) a uniform circuit breaker pilot program designed to halt trading in a disorderly market; (2) pilot

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23 *See* Release No. 34-63241, *Risk Management Controls for Brokers or Dealers with Market Access* (November 3, 2010), http://www.sec.gov/rules/final/2010/34-63241.pdf

24 *See* Release No. 34-64976, *Large Trader Reporting* (July 27, 2011), http://www.sec.gov/rules/final/2011/34-64976.pdf

25 *See* Release No. 34-62174, *Consolidated Audit Trail (*May 26, 2010), http://www.sec.gov/rules/proposed/2010/34-62174.pdf.

exchange rules designed to improve the process of breaking "clearly erroneous" trades; and (3) exchange rules to enhance quotation standards for market makers. In addition, TM has coordinated proposed SRO efforts to implement a "limit-up/limit-down" mechanism that would directly prevent trades outside specified parameters, while allowing trading to continue within those parameters. This procedure should prevent many anomalous trades from ever occurring, as well as limiting the disruptive effect of those that do occur. Similarly, TM has assisted the preparation of proposed updates to the market-wide circuit breakers.

- *Supporting Critical Market Infrastructure and Operations*. TM performs cyclical reviews of exchanges, ECNs, and clearing agencies to ensure they are acting in accordance with the Commission's Automation Review Policies (ARP) and have adequate systems in place to deal with technology disruptions. TM plans to enhance its ARP reviews, with a particular focus on whether registered entities have appropriate cybersecurity measures, and is preparing recommendations for the Commission to further strengthen the ARP standards.

- *Advancing a Comprehensive Review of Equity Market Structure*. In January 2010, the SEC published a concept release on equity market structure in order to solicit public input on several of the key issues highlighted by the explosive growth in trading volume: (1) the quality of performance of the current market structure; (2) high frequency trading; and (3) undisplayed liquidity in all its forms.[26] In addition to considering the more than 200 comment letters that the Commission received, TM organized a Commission-hosted public roundtable on market structure in June 2010. TM plans to continue to advance this discussion and consider whether any rulemaking responses are warranted.

Regulation for Clearing Agencies
TM currently participates in the regulation of 8 active clearing agencies that are examined by the Commission, and anticipates that a number of additional clearing agencies may become subject to Commission oversight in the next few years. TM has significant ongoing responsibilities with respect to clearing agencies, including the review of new clearing agency registration applications and rule changes; engaging in rulemaking, including adopting new prudential standards and monitoring risk-related issues utilizing the recently created Clearing Agency Monitoring group.

These responsibilities were expanded by Title VIII of the Dodd-Frank Act, which provides for enhanced oversight of financial market utilities (FMUs), including clearing agencies registered with the Commission, and payment, clearing or settlement activities that are designated as systemically important. TM worked closely with the staffs of the CFTC and the Federal Reserve Board (the Board) to propose requirements that would require clearing agencies, among other things, to maintain certain standards with respect to risk management and operations, have procedures that identify and address conflicts of interest, and require minimum governance standards for boards of directors. Many of the proposed requirements would apply to all clearing

26 *See* Release No. 34-61358, *Concept Release on Equity Market Structure* (January 14, 2010), http://www.sec.gov/rules/concept/2010/34-61358.pdf

agencies, while others would focus more specifically on clearing agencies that clear security-based swaps.[27]

Additionally, as directed by Title VIII, TM worked jointly with the staffs of OCIE, the CFTC and the Board over the past year to develop a report to Congress reflecting recommendations regarding risk management supervision of clearing entities designated as systemically important by the FSOC. The report should establish a strong framework for ongoing consultation and cooperation in clearing agency oversight among the Commission, the CFTC, and the Board.

Regulation for Broker-Dealers

The Division is responsible for regulations governing close to 5,000 registered broker-dealers, including by:

- Establishing or approving rules governing broker-dealer activities, including rules pertaining to capital adequacy, the protection of customer assets, anti-money laundering, sales practices and record-keeping.

- Reviewing, on an ongoing basis and together with OCIE, the financial activities of certain "risk-supervised broker-dealers," and reviewing filings of other broker-dealers with respect to their material affiliates.

TM is continuing to recommend improvements to the rules in this area. Most recently, in June 2011, the Commission proposed amendments to the broker-dealer financial reporting rules, which are intended to strengthen requirements regarding broker-dealers' custody of customer funds and securities.[28] These amendments would, among other things, facilitate the ability of the PCAOB to implement oversight of independent public accountants of broker-dealers, as required by the Dodd-Frank Act, and eliminate potentially redundant requirements for certain broker-dealers affiliated with, or dually-registered as, investment advisers. The amendments also would enhance the ability of the Commission and SRO examiners to oversee broker-dealers' custody practices by requiring broker-dealers to provide additional information to the Commission.

Regulation for Credit Rating Agencies

TM currently makes rule recommendations for the Commission's consideration applicable to the several credit rating agencies registered with the Commission as NRSROs, reviews applications from potential new registrants and, in conjunction with OCIE, monitors their activities.

Under the Dodd-Frank Act, these responsibilities were expanded significantly, with the Commission required to undertake approximately a dozen rulemakings related to NRSROs. The Commission adopted the first of these required rulemakings in January, and in May, the

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27 *See* Release No. 34-64017, *Clearing Agency Standards for Operation and Governance* (March 3, 2011), http://www.sec.gov/rules/proposed/2011/34-64017.pdf.

28 *See* Release No. 34-64676, *Broker-Dealer Reports* (June 15, 2011), http://www.sec.gov/rules/proposed/2011/34-64676.pdf

Commission published for public comment a series of proposed rules that would largely implement the Dodd-Frank Act requirements by requiring NRSROs to, among other things:[29]

- Report on their internal controls;
- Better protect against any conflicts of interest;
- Establish professional standards for their credit analysts;
- Publicly provide – along with the publication of any credit rating – disclosure about the credit rating and the methodology used to determine it; and
- Provide enhanced public disclosures about the performance of their credit ratings.

The proposals also would require disclosure concerning third-party due diligence reports for asset-backed securities.

The Dodd-Frank Act also requires the SEC to conduct three studies relating to credit rating agencies. In December, the Commission requested public comment on the feasibility and desirability of standardizing credit rating terminology.[30] The Dodd-Frank Act also requires: (1) a 2012 study on alternative compensation models for rating structured finance products; and (2) a 2013 study on NRSRO independence.

With respect to alternative compensation models, the Dodd-Frank Act directs the Commission to study the credit rating process for structured finance products and the conflicts associated with the "issuer-pay" and the "subscriber-pay" models. It further requires the Commission to study the feasibility of establishing a system in which a public or private utility or a self-regulatory organization would assign NRSROs to determine the credit ratings for structured finance products. Accordingly, in May the Commission published a request for public comment on the feasibility of such a system, asking interested parties to provide comments, proposals, data, and analysis by September.[31]

TM is also working with OCIE to assist in the annual examination of each NRSRO, as mandated by the Dodd-Frank Act.

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29 *See* Release No. 34-64514, *Proposed Rules for Nationally Recognized Statistical Rating Organizations* (May 18, 2011), http://www.sec.gov/rules/proposed/2011/34-64514.pdf. The Dodd-Frank Act also requires regulatory agencies to remove references to credit ratings from their regulations and to substitute such standards of creditworthiness as the agencies determine to be appropriate. As part of a Commission-wide effort to meet this requirement, in April 2011, the Commission proposed to remove references to credit ratings in rules concerning broker-dealer financial responsibility, distributions of securities, and confirmations of transactions. *See* Release No. 34-64352, *Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934* (April 27, 2011), http://www.sec.gov/rules/proposed/2011/34-64352.pdf.

30 *See* Release No. 34-63573, *Credit Rating Standardization Study* (December 17, 2010), http://sec.gov/rules/other/2010/34-63573.pdf.

31 *See* Release No. 34-64456, *Solicitation of Comment to Assist in Study on Assigned Credit Ratings* (May 10, 2011), http://www.sec.gov/rules/other/2011/34-64456.pdf.

Regulation for the Municipal Securities Market
TM currently administers the rules of the Commission with respect to the practices of municipal securities brokers and dealers and municipal advisors. It also reviews rule filings by the Municipal Securities Rulemaking Board (MSRB), coordinates with the MSRB in rulemaking and enforcement actions, and advises the Commission on policy matters relating to the municipal bond market.[32]

Under the Dodd-Frank Act, TM is responsible for adopting rules to implement a new registration regime for municipal advisors. Specifically, as of October 1, 2010, the Act made it unlawful for any municipal advisor to provide advice to a municipality unless registered with the Commission. In September 2010, the Commission adopted an interim final rule establishing a temporary means for municipal advisors to satisfy the registration requirement.[33] In December, the Commission proposed a permanent rule creating a new process by which municipal advisors must register with the SEC.[34] The Commission received over 1,000 comment letters on the proposal, including many expressing concerns regarding the treatment of appointed officials and traditional banking products and services. TM is carefully considering all of these comments in preparing its recommendation for the Commission. In addition, working with other Divisions and offices, TM is supporting the Commission's broad-based review of the municipal securities market, including the three public field hearings held to date and the preparation of a staff report concerning the state of the market.

Enforcement Liaison
The Division regularly provides technical assistance to the Division of Enforcement on enforcement matters. In 2011, TM responded to over 950 inquiries from that Division, and we are on track to address over 1,000 inquiries this year.

Investor / Market Participant Guidance
TM also responds to calls, emails, correspondence and other communications from industry, counsel, the public, congressional staff, foreign sources and others. Last year, the Division handled roughly 15,000 such communications and processed roughly 1,000 tips, complaints, referrals, and regulated entity notices. TM also issues written interpretive guidance to market participants.

International Coordination
The globalization of securities markets requires TM to coordinate its regulatory activities with its foreign counterparts on an ongoing bilateral and multilateral basis. The active participation of

32 The Dodd-Frank Act envisions that the credit rating agency and municipal securities functions currently being carried out by TM will eventually be folded into separate offices. The Dodd-Frank Act requires the Commission to create several offices within the Commission, including the Office of Credit Ratings, and the Office of Municipal Securities. Each of these offices is statutorily required to report directly to the Chairman, the creation of these offices is subject to approval by the Commission's appropriations subcommittees to reprogram funds for this purpose. Until reprogramming approval is received, the initial functions of the offices are being performed on a limited basis by other divisions and offices.

33 *See* Release No. 34-62824, *Temporary Registration of Municipal Advisors* (September 1, 2010), http://www.sec.gov/rules/interim/2010/34-62824.pdf.

34 *See* Release No. 34-63576, *Registration of Municipal Advisors* (December 20, 2010), http://sec.gov/rules/proposed/2010/34-63576.pdf.

TM staff with technical expertise in international working groups – with, among others, the Financial Stability Board (FSB), the International Organization of Securities Commissions (IOSCO), the Financial Action Task Force, and the Joint Forum – is essential to the fulfillment of the Commission's responsibilities. TM staff serves in a leadership capacity in a number of these groups, including, the FSB Working Group on OTC Derivatives, the Committee on Payment and Settlement Systems (CPSS)-IOSCO group on Principals for Financial Market Infrastructures, the IOSCO Standing Committee on Credit Rating Agencies, and the IOSCO Task Force on OTC Derivatives Regulation. Through such participation, the staff works to represent the interests of U.S. investors and markets on relevant international issues.

Additional Responsibilities under the Dodd-Frank Act

In addition to substantially expanding many of TM's core functions, the Dodd-Frank Act also calls for the development of: (1) a registration and regulatory regime for entities that participate in the security-based OTC derivatives market; (2) new restrictions upon proprietary trading activities of certain entities under the "Volcker Rule", as well as prohibitions involving conflicts of interest related to certain securitizations; and (3) new coordination mechanisms with other regulatory agencies, most notably through the Financial Stability Oversight Council (FSOC).

Regulation of OTC Derivatives

Title VII of the Dodd-Frank Act establishes a new regulatory regime for the OTC derivatives market and requires the Commission to write rules that address, among other things: business conduct, capital, and margin requirements for market intermediaries; mandatory clearing requirements; the operation of security-based swap data repositories and trade execution facilities; and public transparency for security-based swap price and other transaction information. To date, the Commission has proposed rules in thirteen areas required by Title VII:

- Rules prohibiting fraud and manipulation in connection with security-based swaps;[35]

- Rules regarding trade reporting, data elements, and real-time public dissemination of trade information for security-based swaps that would lay out who must report security-based swaps, what information must be reported, and where and when it must be reported;[36]

- Rules regarding the obligations of security-based swap data repositories that would require them to register with the SEC and specify the extensive confidentiality and other requirements with which they must comply;[37]

[35] *See* Release No. 34-63236, *Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps* (November 3, 2010), http://www.sec.gov/rules/proposed/2010/34-63236.pdf.

[36] *See* Release No. 34-63346, *Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information* (November 19, 2010), http://www.sec.gov/rules/proposed/2010/34-63346.pdf.

[37] *See* Release No. 34-63347, *Security-Based Swap Data Repository Registration, Duties, and Core Principles* (November 19, 2010), http://www.sec.gov/rules/proposed/2010/34-63347.pdf.

- Joint rules with the CFTC regarding the definitions of swap and security-based swap dealers, and major swap and security-based swap participants;[38]

- Rules relating to mandatory clearing of security-based swaps that would establish a process for clearing agencies to provide information to the SEC about security-based swaps that the clearing agencies plan to accept for clearing;[39]

- Rules regarding the exception to the mandatory clearing requirement for hedging by end users that would specify the steps that end users must follow, as required under the Act, to notify the SEC of how they generally meet their financial obligations when engaging in security-based swap transactions exempt from the mandatory clearing requirement;[40]

- Rules defining and regulating security-based swap execution facilities, which specify their registration requirements, and establish the duties and implement the core principles for security-based swap execution facilities specified in the Act;[41]

- Rules regarding the confirmation of security-based swap transactions that would govern the way in which certain of these transactions are acknowledged and verified by the parties who enter into them;[42]

- Rules regarding certain standards that clearing agencies would be required to maintain with respect to, among other things, their risk management and operations;[43]

- Joint rules with the CFTC regarding further definitions of the terms "swap", "security-based swap," and "security-based swap agreement"; the regulation of mixed swaps; and security-based swap agreement recordkeeping;[44]

- Rules regarding business conduct that would establish certain minimum standards of conduct for security-based swap dealers and major security-based swap participants,

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38 *See* Release No. 34-63452, *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant,""Major Security-Based Swap participant" and "Eligible Contract Participant"* (December 7, 2010), http://www.sec.gov/rules/proposed/2010/34-63452.pdf.

39 *See* Release No. 63557, *Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations* (December 15, 2010), http://www.sec.gov/rules/proposed/2010/34-63557.pdf.

40 *See* Release No. 34-63556, *End-User Exception of Mandatory Clearing of Security-Based Swaps* (December 15, 2010), http://www.sec.gov/rules/proposed/2010/34-63556.pdf.

41 *See* Release No. 34-63825, *Registration and Regulation of Security-Based Swap Execution Facilities* (February 2, 2011), http://www.sec.gov/rules/proposed/2011/34-63825.pdf.

42 *See* Release No. 34-63727, *Trade Acknowledgment and Verification on Security-Based Swap Transactions* (January 14, 2011), http://www.sec.gov/rules/proposed/2011/34-63727.pdf.

43 *See* Release No. 34-64017, *Clearing Agency Standards for Operation and Governance* (March 2, 2011), http://www.sec.gov/rules/proposed/2011/34-64017.pdf.

44 *See* Release No. 33-9204, *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping* (April 29, 2011), http://www.sec.gov/rules/proposed/2011/33-9204.pdf.

including in connection with their dealings with "special entities", which include municipalities, pension plans, endowments and similar entities;[45]

- Rules regarding the registration process for security-based swap dealers and major security-based swap participants;[46] and

- Rules intended to address conflicts of interest at security-based swap clearing agencies, security-based swap execution facilities, and exchanges that trade security-based swaps.[47]

The Commission also adopted an interim final rule regarding the reporting of outstanding security-based swaps entered into prior to the date of enactment of the Dodd-Frank Act.[48] TM is continuing to develop other proposed rules required by Title VII for the Commission's consideration, including proposals to address capital, margin, and segregation requirements. Additionally, the Division is working to develop proposed rules concerning the treatment of cross-border security-based swap transactions, as well as an implementation plan that will aim to permit the roll-out of the new security-based swap requirements in a logical, progressive, and efficient manner.

Going forward, TM's regulatory responsibilities will be significantly expanded by the addition of the new categories of registered entities, the required regulatory reporting and public dissemination of security-based swap data, and the mandatory clearing of security-based swaps. In coordination with OCIE and the other Divisions, TM will be responsible for the registration and other rules for four entirely new categories of entities: security-based swap execution facilities (SEFs) (an estimated 20 new registrants within a year of the adoption of final rules); security-based swap data repositories (SDRs) (an estimated three new registrants within a year of the adoption of final rules); security-based swap dealers (an estimated 50 new registrants within a year of adoption of final rules); and major security-based swap participants. TM also will need to: (1) monitor market developments and develop new rules for Commission consideration and provide guidance where needed; (2) respond to numerous interpretive requests in connection with the requirements applicable to the new registrants; and (3) as applicable, review new rule and product submissions by security-based swap execution facilities.

Volcker Rule & Conflicts of Interest in Certain Securitizations

Volcker Rule. In January 2011, FSOC approved and released to the public a study formalizing its findings and recommendations for implementing Section 619 of the Dodd-Frank Act,

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[45] *See* Release No. 34-64766, *Business Conduct Standards for Security-Based Swaps Dealer and Major Security-Based Swap Participants* (June 29, 2011), http://www.sec.gov/rules/proposed/2011/34-64766.pdf.

[46] *See* Release No. 34-65543, *Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants* (Oct. 12, 2011), http://sec.gov/rules/proposed/2011/34-65543.pdf .

[47] *See* Release No. 34-63107, *Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC* (October 14, 2010), http://www.sec.gov/rules/proposed/2010/34-63107.pdf.

[48] *See* Release No. 34-63094, *Reporting of Security-Based Swap Transaction Data* (October 13, 2010), http://www.sec.gov/rules/interim/2011/34-63094.pdf.

commonly referred to as the Volcker Rule.[49] Section 619, among other things, generally prohibits: (i) federally insured depository institutions and their affiliates (banking entities) from engaging in short-term proprietary trading of any security, derivative, and certain other financial instruments for a banking entity's own account and (ii) owning, sponsoring, or having certain relationships with a hedge fund or private equity fund. The Commission staff worked closely with staffs from the federal banking agencies and the CFTC in drafting proposed rules to implement Section 619, and on October 12, 2011, the Commission issued the proposal jointly with the Federal Deposit Insurance Corporation, the Board, and the Office of the Comptroller of the Currency.[50] The Commission's proposed rule would apply to banking entities that are SEC-registered broker-dealers, investment advisers, and security-based swap dealers, among others.

Under the jointly-proposed rule, transactions in certain instruments would be exempt from the prohibition on proprietary trading, including obligations of U.S. government or a U.S. government agency, government-sponsored enterprises, and state and local governments. Additionally, the proposal, like the statute, would exempt activities such as market making, underwriting, and risk-mitigating hedging.

Banking entities would be required to establish an internal compliance program subject to supervisory oversight and designed to ensure and monitor compliance with the prohibitions and restrictions of Section 619. The proposal also would require firms with significant trading operations to report to the appropriate federal supervisory agency certain quantitative measurements designed to assist the supervisory agency and banking entities in identifying prohibited proprietary trading from permitted market making-related activities, among other purposes.

Section 621. In September 2011, the Commission proposed for comment a new rule under the Securities Act of 1933 to implement the prohibition under Section 621 of the Dodd-Frank Act concerning material conflicts of interest in connection with securitizations. Section 621 prohibits entities that create and distribute asset-backed securities from engaging in transactions that involve or result in material conflicts of interest with respect to the investors in such asset-backed securities.

Interagency Coordination

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

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[49] The FSOC Volcker Rule study and recommendations can be found at http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf. *See also* http://sec.gov/spotlight/dodd-frank/volckerrule.htm.

[50] *See* Release No. 34-65545, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships with, Hedge Funds and Private Equity Funds (October 12, 2011), http://www.sec.gov/rules/proposed/2011/34-65545.pdf.*

OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS

Director, Carlo di Florio [51]

The Office of Compliance Inspections and Examinations (OCIE) supports the SEC's mission to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation by conducting risk-based examinations across the country through the Commission's National Examination Program ("NEP"). These examinations cover investment advisers, investment companies, broker-dealers, municipal advisors, municipal securities dealers, transfer agents, credit rating agencies, clearing agencies, exchanges, and other SROs such as FINRA, and the MSRB. The results of OCIE's examinations are utilized by the Commission to inform rule-making initiatives, to identify and monitor risks, to improve industry practices and to pursue misconduct.

Recent Internal Reforms

Over the past two years, OCIE has undertaken a broad self-assessment of its strategy, structure, people, processes and technology. This has resulted in a comprehensive improvement plan to break down silos and promote a high-performance culture. OCIE continues to implement key program improvement initiatives in the following areas:

Strategy – Strengthening Our Governance and Risk-Focusing our National Exam Program. OCIE is implementing many reforms to an integrated National Exam Program designed to achieve consistency, effectiveness and efficiency. The cornerstone is a national governance model and enhanced risk-focused exam strategy to better allocate and leverage limited resources to their highest and best use. Both of these were implemented in 2011.

Structure – Strengthening Expertise in Critical Risk Areas. OCIE is implementing significant structural enhancements to support the National Exam Program and a risk-focused exam strategy. This restructuring will strengthen expertise and facilitate teamwork, while driving greater consistency, effectiveness and accountability. In 2011, the steps to implement this initiative included:

- Creating a centralized Risk Assessment and Surveillance Unit to enhance the ability of the National Exam Program to perform more sophisticated data analytics to identify the firms and practices that present the greatest risks to investors, markets and capital formation; and
- Enhancing the large firm monitoring program through engagement of senior management and boards on critical risk and regulatory issues, and public reports on issues that the NEP has identified as key risk concerns.

People – Recruiting Specialists, Improving Training and Strengthening Culture. OCIE has been recruiting people with new skill sets that are critical to supervising our modern capital markets. We also are building a leading practice training program. To that end,we introduced mentoring, project-based staffing, and other steps to build a culture of high-

[51] Mr. di Florio joined the SEC as the Director of OCIE in January 2010. http://www.sec.gov/news/press/2010/2010-1.htm

performance, teamwork and accountability. In 2011, the steps to implement this initiative included:

- Recruiting experts to deepen program knowledge and experience in areas such as derivatives, complex structured products, hedge funds and credit rating agencies; and
- Strengthening examiner skill sets through the development of an examiner training program.

Process – Streamlining Processes to Drive Consistency, Effectiveness and Efficiency. We are re-engineering our exam process end-to-end. This enables us to target more risk-focused examinations, enhance pre-exam preparation, improve multidisciplinary staffing, and increase field supervision. In FY 2011, we conducted approximately 1600 examinations.

Technology – Automating and Improving the Exam Process to Keep Pace with New Developments. We are focusing our technology strategy on moving from a manual to an automated exam process where possible. This includes enhancing information gathering to help automate risk assessment and surveillance and improving exam preparation and providing tools and techniques to enhance key activities associated with exam execution, such as work paper management, trade analysis and other data analytics and reporting. In 2011, we developed and brought on board a number of new tools and technologies to enhance program efficiency and effectiveness.

Governance, Enterprise Risk Management and Internal Controls. The financial crisis revealed just how dramatically risk management failures can harm investors, jeopardize market integrity and hinder capital formation. It also revealed the need for better oversight of risk at the board and senior management levels, and the need for stronger independence, standing and authority among a firm's internal risk management, control and compliance functions. As a result, where appropriate we focus our exams on the overall governance and risk management framework of a firm so we can assess the firm's system of checks and balances.

National Examination Program Strategic Objectives

The National Exam Program seeks to advance the SEC's mission through risk-focused strategies that (1) improve compliance; (2) prevent fraud; (3) inform policy, and (4) monitor firm-wide and systemic risk. In the coming fiscal year we will pursue our four strategic objectives by further implementing our risk-based examination strategy, addressing the implementation of Dodd-Frank Act requirements, and enhancing intra-agency and inter-agency coordination.

Further Implement Risk-Focused Exam Strategy. The NEP considers the national exam priorities and information from multiple sources to identify focus areas to review as well as which registrants to examine. We will tailor the scope of our examinations based on identified risks through our understanding of, for example, the registrant's business model (e.g., revenue streams, profit centers, products, business plans), affiliations and conflicts of interest, and control environment. OCIE now reviews and evaluates tips, complaints and referrals in accordance with the new national TCR system and related policies. Particular attention is given to TCRs that provide allegations or indications of fraud and surprise custody audits that identify qualified opinions and material discrepancies. This process helps inform the selection of registrants for examination and the scope of such exams.

As we identify risk trends or emerging risks in the course of the examination program, we will communicate this information to our examination staff. We will also publish reports and risk alerts describing notable risks, as well as observations about effective methods for addressing these risks that the NEP staff has observed. Through these public reports we will seek to encourage and strengthen the effectiveness of registrants' risk management and compliance programs in recognizing and appropriately addressing key risks.

Implement Dodd-Frank Act Requirements. The Dodd-Frank Act imposes significant additional responsibilities on the NEP, including the registration and examination of new entities, such as certain private fund advisers, private equity firms, municipal advisors and five new categories of swap/derivatives registrants. In addition, the Dodd-Frank Act significantly increases oversight expectations with regard to existing registrants, such as credit rating agencies, clearing agencies and FINRA. In FY 2012, the NEP will continue to adapt its infrastructure (e.g., examination tools and techniques, as well as other resources) to effectively accomplish the Dodd-Frank mandates, as well as contribute more broadly to the agency's work on rulemaking, related studies, and implementation of the Dodd-Frank Act.

Enhance Intra-Agency and Inter-Agency Coordination. We will continue to collaborate with staff from the other Divisions and Offices as well as our regulatory counterparts, to share information, identify areas of interest or potential regulatory risk, and coordinate examinations. Within the Commission, we have been working closely with colleagues in other divisions and offices at all levels. For example, in addition to giving input in myriad rulemakings, we have conducted numerous joint training exercises, been in almost constant contact with other divisions on changes to forms such as ADV, FOCUS and BD, as well as on examination priorities, planning and review, and made joint inquiries to the industry in response to emergency issues, such as the May 6, 2010 Flash Crash or MF Global. Our collaboration with the Division of Enforcement has been particularly close. We have formed joint referral committees to make sure that there is close communication on referrals from the moment they are made through the course of any ensuing investigation.

Outside the SEC, we have collaborated with SROs, firms, regulatory counterparts at federal banking agencies, the CFTC, and state regulators on a wide range of examination priorities and regulatory initiatives. For example, pursuant to Section 813 of the Dodd-Frank Act, on July 21, 2011 the Commission reported jointly to Congress with the CFTC and the Federal Reserve Board how we will collaborate to identify emerging risks, advance supervisor oversight, and promote enhanced risk management practices for designated clearing entities.

Programmatic Priorities for FY 2012. Pursuant to our risk-based approach to prioritizing examinations, we have identified certain likely areas of emphasis in each of our program areas for the coming year. These program areas are the broker-dealer exam program, the investment management exam program, the market oversight exam program, the clearance and settlement exam program, and the credit rating agency exam program.

Broker-Dealer Exam Program. This program will provide a risk-based focus to the program and also assist in selecting particular broker-dealers for examination. Since broker-dealer examinations may involve activities by enterprises with related entities registered in multiple capacities and acting in concert (e.g., broker-dealer, investment adviser, transfer agent, etc.), examination activities will be coordinated as appropriate. Some of the areas of focus include, new issue diligence, supervision of broker-dealer employees, fraud, unregistered activities, trading risks, new regulatory risks (e.g., compliance policies and procedures related to Dodd-Frank Act requirements or the new Market Access Rule), risks posed by large and complex firms, and enhanced collaboration with other regulatory authorities.

Investment Management Exam Program. The Investment Management Exam Program is responsible for examinations of numerous types of registrants. In FY2012, focus areas for the Investment Management Program include complex entities, fund governance, risk management, fraudulent activities and safety of assets, and performance and advertising.

Market Oversight Exam Program. The Market Oversight Program is responsible for examining certain SROs and other entities compliance with applicable federal securities laws and rules and the SRO's own rules. As of September 2011, the population subject to examination by Market Oversight included 15 national securities exchanges, FINRA, MSRB, PCAOB, and SIPC. The priorities in FY2012 in this area include risk assessment examinations based on SRO assessments, enhanced oversight of FINRA and other entities, Section 31 fee examinations, and examinations of potential new registrants.

Clearance and Settlement Program. The Clearance and Settlement Program currently oversees transfer agents and clearing agencies. In addition, if the Commission adopts final rules for Security-based Swap Data Repositories (SB SDRs) requiring registration with the Commission, the Clearance and Settlement Program will take on the responsibility within OCIE for conducting examinations of SB SDRs. The priorities for the Clearance and Settlement Program currently include: the Transfer Agent Program, the Clearing Agency Program and the Security-based Swap Data Repository Program

Credit Rating Agency Program. The Dodd-Frank Act requires the Commission to establish an independent "Office of Credit Ratings" to administer the Commission's rules with respect to credit rating agencies registered as NRSROs. The specific duties of this new office include annual examinations of each NRSRO and an annual report summarizing the examinations.

OCIE and TM have worked closely together to achieve the office's goals. In particular, OCIE has created an office within the NEP for NRSRO examinations. This office, with help from examiners from other OCIE examination areas and from members of TM's NRSRO monitoring unit, successfully completed the first set of annual examinations of each NRSRO, and the Commission approved publishing the staff's summary report of those examinations.

Upcoming Challenges

Our new risk-based approach is driven in part by the simple fact that our current examination resources can only cover an ever smaller portion of the registrants that we are responsible for examining. Only eight percent of registered advisers were examined in FY 2011 and approximately 38 per cent of advisers registered with the SEC have never been examined. Additionally, out of more than 160,000 broker-dealer branch offices, less than one percent of these offices are examined by either the SEC or FINRA annually.

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

Keeping up with these changes requires not only greater training and expertise, but also better technology. For example, high frequency trading has grown over the past six years from approximately 20 percent of trading volume in U.S. equities to well over 60 percent, and is likely to increase further. In order for the examination program to monitor developments in that market in a timely manner will require greater resources for data collection and processing as well as expertise to analyze these data feeds. Hedge funds and other complex financial entities and products pose similar technological challenges.

The Dodd-Frank Act shifted the responsibility for examining many smaller advisers to the states. However, the Dodd-Frank Act expanded the SEC's responsibilities by adding to its jurisdiction municipal advisors, as well as a large number of complex entities, such as five new categories of securities-based swap participants as well as hedge fund and other private fund advisers. The staff recently concluded, as a result, that the Commission likely will not have sufficient capacity in the near or long term to conduct effective examinations of registered investment advisers with adequate frequency.

The result of these changes in the registrant population will play out during FY2012. Overall, the approximately 25,000 registrants in the SEC regulated community in FY 2012 will dwarf the size of the current examination program (currently slightly less than 900 total staff nationwide). At current funding levels, we will not be able to expand our supervision of the population of current and future supervised entities.

INVESTMENT MANAGEMENT

Director, Eileen Rominger[52]

The Division of Investment Management ("IM") assists the Commission in executing its responsibility for investor protection and for promoting capital formation through oversight and regulation of America's $43 trillion investment management industry. IM's core mission is to administer the Investment Company Act of 1940 ("Investment Company Act") and the Investment Advisers Act of 1940 ("Advisers Act") and oversee and develop regulatory policy for investment advisers, mutual funds and other investment companies. IM carries out its mission through the following main programs:

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

- ***Interpretive Advice and Exemptive Relief.*** IM provides formal and informal legal guidance in the form of interpretive and no-action letters, exemptive relief, interpretive releases, memoranda, and other letters and materials. In FY 2010, the staff closed 1,325 matters involving formal and informal legal guidance.

- ***Review of Filings.*** IM reviews filings of investments companies that register under the Investment Company Act and register their securities under the Securities Act of 1933 to both monitor and enhance compliance with disclosure and accounting requirements. The filings reviewed include initial registration statements, post-effective amendments thereto, proxy statements, and annual and period reports. In FY 2010, the staff reviewed 18,976 filings. Under Commission rules, some filings containing non-material changes or disclosure that is substantially similar to a prior filing may not be subject to staff review or may be subject to a limited review. Pursuant to requirements under the Sarbanes-Oxley Act of 2002, IM reviews the annual reports of all investment companies no less frequently than once every three years. In FY 2010, such reviews amounted to 4,741.

- ***Enforcement Liaison.*** IM regularly provides formal and informal legal and policy guidance to the Division of Enforcement on enforcement matters. In FY 2011, IM reviewed over 474 enforcement-related matters from the Division of Enforcement, and expects to review approximately the same number of enforcement-related matters in FY 2012. In addition, IM conducts reviews of disciplinary disclosures in new or amended Form ADVs filed by registered investment advisers to assess whether there are grounds to bring actions against the adviser or any of their associated persons. IM also works with the Division of Enforcement on IM-related tips, complaints and referrals.

- ***Rulemaking.*** In the last year, IM has been focusing its rulemaking program on implementing the provisions of the Dodd-Frank Act as they relate to investment companies and advisers, and, as rules are adopted, much of the work will shift to the Division's disclosure, interpretive advice and exemptive relief programs. Provided below is a list and brief description of the recent Dodd-Frank implementation rules IM was responsible for implementing.

Adopted Rules

Investment Adviser Regulation. The Dodd-Frank Act changed the population of investment advisers that must register with the Commission in two significant ways. First, the Dodd-Frank Act increased from $25 million to $100 million in assets under management the statutory threshold for Commission registration. Second, the Dodd-Frank Act eliminated the "private adviser" exemption, which exempted from registration many advisers to hedge funds and other private funds. Advisers that do not meet the new asset threshold may have to withdraw their registrations with the Commission and register instead in their home states. Furthermore, advisers to hedge funds and other private funds will be required to register with the Commission or qualify for one of the narrower exemptions added by the Dodd-Frank Act.

In June 2011, the Commission adopted new rules and rule amendments that: (1) reallocate primary responsibility for oversight of certain advisers to the states; (2) provide for an orderly transition to state registration for advisers that will no longer be eligible to register with the Commission; and (3) provide a transition period until March 30, 2012 for advisers that previously relied on the "private adviser" exemption to register with the Commission and come into compliance with the Advisers Act.[53] The staff estimates that, as a result, approximately 750 private fund advisers will have to register with the Commission and approximately 3,200 small advisers will withdraw their registrations. While the staff expects the number of registered advisers to decrease overall by 28 percent, the total assets managed by advisers registered with the Commission are expected to rise.

Concurrently, the Commission adopted rules to implement new adviser registration exemptions created by the Dodd-Frank Act.[54] The new rules implement new exemptions for advisers solely to venture capital funds (by defining the term "venture capital fund") and advisers solely to private funds with less than $150 million in assets under management in the United States. The new rules also clarify the meaning of certain terms included in the new exemption for foreign private advisers.

The Commission also adopted rules that require advisers registered with the Commission to provide information about the private funds that they advise, as well as information regarding their relationships with other affiliated financial institutions. Advisers that do not register, either because they are advising only venture capital funds or have less than $150 million in private fund assets under management in the United States, are subject to a more limited reporting obligation.

Family Offices. In June 2011, the Commission adopted a new rule defining "family offices" that will be excluded from the definition of an investment adviser under the Advisers Act and thus will not be subject to regulation under the Advisers Act.[55] Family offices are entities established by wealthy families to manage their money and provide tax and estate planning and similar services. Historically, family offices have not been required to register with the Commission because of an exemption for private advisers. The Dodd-Frank Act eliminated that exemption to enable the Commission to regulate advisers to hedge funds and other private funds (as discussed above), but included a new provision requiring the Commission to define family offices in order to exempt them from regulation under the Advisers Act. The Commission defined a family office as any firm that: (1) provides investment advice only to family members, as defined by the rule; certain key employees; and certain family entities; (2) is wholly owned by family clients, as defined by the rule, and controlled by family members or certain family entities; and (3) does not hold itself out to the public as an investment adviser.

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[53] *See* Release No. IA-3221, *Rules Implementing Amendments to the Investment Advisers Act of 1940* (June 22, 2011), http://www.sec.gov/rules/final/2011/ia-3221.pdf.

[54] *See Release No. IA-3222, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers* (June 22, 2011)), http://www.sec.gov/rules/final/2011/ia-3222.pdf.

[55] *See* Release No. IA-3220, *Family Offices* (June 22, 2011), http://www.sec.gov/rules/final/2011/ia-3220.pdf.

Form PF. The Dodd-Frank Act mandated that the Commission require private fund advisers (including hedge and private equity fund advisers) to confidentially report information about the private funds they manage for the purpose of the assessment of systemic risk by the Financial Stability Oversight Council ("FSOC"). On October 31, 2011, in a joint release with the CFTC, based on a staff consultation with staff representing members of FSOC, the Commission adopted a new rule that requires hedge fund advisers and other private fund advisers to report systemic risk information on a new form ("Form PF").[56] Under the new rule, registered investment advisers managing at least $150 million in private fund assets will periodically file Form PF. The data collection would dovetail with the enhanced private fund reporting discussed above for investment advisers registered with the Commission.

The Form PF reporting requirements are scaled to the adviser. Advisers with less than a certain amount of hedge fund, liquidity fund or private equity fund assets under management will report only very basic information on an annual basis. Advisers over specified thresholds will report more information, and large hedge fund and liquidity fund advisers also will report on a quarterly basis. This approach ensures that FSOC will have a broad picture of the industry while relieving smaller advisers from much of the reporting requirements. In addition, the reporting requirements are tailored to the types of funds that an adviser manages and the potential risks those funds may present, meaning that an adviser will respond only to questions that are relevant to its business model. The Commission does not intend to make public Form PF information identifiable to any particular adviser or private fund, although the Commission may use the data in an enforcement action. The Dodd-Frank Act provides special confidentiality protections for this data. The initial stages of this reporting will begin next year.

Pay to Play. In July 2010, the Commission adopted an Advisers Act 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.[57] In June 2011, the Commission amended the pay-to-play rule in response to Dodd-Frank Act amendments to the Advisers Act that would have narrowed the application of the rule with respect to certain advisers to private funds.[58] The Commission also amended the rule to permit an adviser to pay a registered municipal advisor, a new Dodd-Frank Act category of SEC-registrants, to solicit government entities on the adviser's behalf. Such municipal advisors, however, must be subject to a pay-to-play rule adopted by the MSRB that the Commission has determined is substantially equivalent to or more stringent than the Commission's pay-to-play rule for investment advisers.

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[56] *See* Release No. IA-3308, *Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF* (October 31, 2011), http://www.sec.gov/rules/final/2011/ia-3308.pdf.

[57] *See* Release No. IA-3043, *Political Contributions by Certain Investment Advisers* (July 1, 2010), http://www.sec.gov/rules/final/2010/ia-3043.pdf.

[58] *See* Release No. IA-3221, *Rules Implementing Amendments to the Investment Advisers Act of 1940* (June 22, 2011), http://www.sec.gov/rules/final/2011/ia-3221.pdf.

Proposed Rules

Volcker Rule. IM assisted the Commission with certain parts of the proposed rule implementing the Volcker Rule. Specifically IM focused on the provisions that relate to investments in and sponsorship of hedge funds and private equity funds by banking entities.[59]

Qualified Clients. In May 2011, the Commission proposed changes to the rule that permits investment advisers to charge clients performance fees.[60] The rule's conditions already include minimum standards, such as net worth, that clients must satisfy for the adviser to charge these fees. The proposed amendments would incorporate the revised dollar amount levels that the Commission adjusted by order this past July to account for the effects of inflation, as required by the Dodd-Frank Act. The amendments also would remove the value of a client's primary residence from the calculation of net worth.

Incentive-Based Compensation Arrangements. The Dodd-Frank Act mandated that financial regulators jointly develop rules or guidelines governing incentive-based compensation practices at certain financial institutions with balance sheet assets of $1 billion or more. On March 29, 2011, the Commission proposed a rule – substantially similar to the rules proposed by the other financial regulators around the same time – that would apply to brokers, dealers and investment advisers with balance sheet assets of at least $1 billion.[61] The proposed rule contains: (1) disclosure requirements about incentive-based compensation arrangements; (2) prohibitions on encouraging inappropriate risk; and (3) provisions concerning policies and procedures for incentive-based compensation arrangements. The comment period on the proposed rule has ended. The staff is considering the various issues raised by the large number of commenters.

Other Significant Initiatives

While IM has been focused on bringing to closure its Dodd-Frank Act related rulemakings, the Division has also been engaged in rulemakings and other initiatives outside of its Dodd-Frank agenda. The most significant of these initiatives include the following:

Use of Derivatives by Investment Companies. In August 2011, the Commission issued a concept release to seek public comment on a wide range of issues raised by the use of derivatives by mutual funds and other investment companies regulated under the Investment Company Act.[62] The concept release is a continuation of the SEC's ongoing review of mutual funds' use of derivatives announced last year. The comment period ended on November 7, 2011. After consideration of public comments, the Division will evaluate recommendations for further action by the Commission.

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[59] *See* Release No. 34-65545, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships with, Hedge Funds and Private Equity Funds* (October 12, 2011), http://www.sec.gov/rules/proposed/2011/34-65545.pdf.

[60] *See* Release No. IA-3198, *Investment Adviser Performance Compensation* (May 10, 2011), http://www.sec.gov/rules/proposed/2011/ia-3198.pdf.

[61] *See* Release No. 34-64140, *Incentive-based Compensation Arrangements* (March 29, 2011), http://www.sec.gov/rules/proposed/2011/34-64140.pdf.

[62] *See* Release No. IC-29776, *Use of Derivatives by Investment Companies under the Investment Company Act of 1940* (August 31, 2011), http://www.sec.gov/rules/concept/2011/ic-29776.pdf.

Asset-Backed Issuers under the Investment Company Act. In August 2011, the Commission also issued an advance notice of proposed rulemaking to seek public input on possible amendments to Rule 3a-7 under the Investment Company Act that the Commission might consider proposing.[63] Rule 3a-7 excludes certain issuers of asset-backed securities from having to comply with the requirements of the Investment Company Act. Among the issues that the Commission set forth for public comment is the role, if any, that credit ratings should continue to play in the context of the rule. The comment period also ended on November 7, 2011 and the Division staff is currently analyzing the comments.

Mortgage-Related Pools under the Investment Company Act. In a companion concept release to the advance notice of proposed rulemaking on Rule 3a-7 for asset-backed issuers, the Commission solicited public comment on interpretive issues relating to some real estate investment trusts and other mortgage-related pools that rely on the exclusion from regulation under the Investment Company Act set forth in Section 3(c)(5)(C) of that Act.[64] The concept release noted concerns that mortgage-related pools potentially are making judgments about their status under the Investment Company Act without sufficient Commission guidance, and that certain mortgage-related pools today appear to resemble investment companies such as closed-end funds and may not be the kinds of companies that were intended to be excluded under the statutory provision. The comment period ended on November 7, 2011 and the Division staff is currently analyzing the comments.

12b-1. In July 2010, the Commission proposed to reform the regulation of distribution fees that are paid by mutual funds and their investors.[65] These fees are a significant method of paying for the distribution of fund shares. Mutual funds paid over $10 billion in distribution fees in 2010. The Commission's proposal would establish limits on these fees, improve disclosures to investors, and promote more competition among broker-dealers in setting market-based fees. The Commission received about 2,400 comment letters in response to its proposal. Most investors and investor advocates supported the proposal, while many industry commenters argued that the proposed changes would be too costly for too little benefit. The Division is evaluating recommendations for further action by the Commission.

Target Date Funds. In June 2010, the Commission proposed changes to rules regarding fund names and marketing materials with respect to target date funds.[66] A target date fund is typically intended for investors whose retirement date is at or around the fund's stated target date. American workers increasingly rely on target date funds for their retirement needs. After consideration of public comments, the Division will evaluate whether to recommend that the Commission adopt rule changes to address target date funds.

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[63] *See* Release No. IC- 29779, *Treatment of Asset-Backed Issuers under the Investment Company Act* (August 31, 2011), http://www.sec.gov/rules/concept/2011/ic-29779.pdf.

[64] *See* Release No. IC-29778, *Companies Engaged in the Business of Acquiring Mortgages and Mortgage-Related Instruments* (August 31, 2011), http://www.sec.gov/rules/concept/2011/ic-29778.pdf.

[65] *See* Release Nos. 33-9128, Mutual Fund Distribution Fees; Confirmations (July 21, 2010), http://www.sec.gov/rules/proposed/2010/33-9128.pdf.

[66] *See* Release Nos. 33-9126, Investment Company Advertising; Target Date Retirement Fund Names and Marketing (June 16, 2010), http://www.sec.gov/rules/proposed/2010/33-9126.pdf.

Money Market Fund Rulemaking, Oversight, and Surveillance. The Commission continues its more extensive oversight and surveillance of money market funds based on detailed monthly portfolio holdings data it began collecting in November 2010. Using this data, IM is able to monitor trends in money market funds' portfolio exposures, liquidity levels and average maturities and is able to discuss these trends and any associated risks with the Commission and with staff representing members of FSOC.

In November 2010, the Commission requested comment on the options discussed in the President's Working Group Report on Money Market Fund Reform Options.[67] Commenters both discussed the options in the President's Working Group Report and raised other options for reform. In May 2011, the Commission sponsored a roundtable to discuss money market funds, systemic risk, and options for further regulatory reform to reduce their systemic risk and susceptibility to runs. IM continues to consult with their counterparts in the other agencies that comprise FSOC on options for further regulatory reform.

Other Functions and Special Projects.

IM also participates in international working groups and engages in other special projects, some of which are highlighted below.

International Coordination. Funds and the advisers that operate them, including private funds and private fund advisers, frequently operate on a global basis. The active participation of IM staff with technical expertise in international working groups, such as IOSCO, is essential to the fulfillment of the Commission's international responsibilities. Such participation helps promote an internationally coordinated approach and standards that are consistent with Commission policy.

Investor Testing. IM is proceeding on several fronts to engage investors about how best to provide them with useful disclosure. We are currently working with the Commission's Office of Investor Education and Advocacy to examine the effectiveness of mutual fund shareholder reports in communicating useful information to individual investors. The Commission staff is also using investor testing as part of a study mandated by Section 917 of the Dodd-Frank Act regarding financial literacy and methods to improve the timing, content, and format of disclosures to investors with respect to financial intermediaries, investment products, and investment services. Finally, the SEC staff is currently conducting investor testing as part of its rulemaking efforts on target date retirement funds.

Cross-Divisional Studies. We have undertaken a number of cross-divisional studies required by the Dodd-Frank Act, including:

- ***Investment Adviser/Broker Dealer Fiduciary Study.*** In January 2011, SEC staff completed a study required by Section 913 of the Dodd-Frank Act that, among other things, evaluated the effectiveness of existing legal or regulatory standards of care for broker dealers and investment advisers when providing personalized investment advice

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[67] *See* Release No. IC-29497, President's Working Group Report on Money Market Fund Reform (November 3, 2010), http://www.sec.gov/rules/other/2010/ic-29497.pdf.

about securities to retail customers.[68] SEC staff recommended that the Commission adopt rules, consistent with Congress' grant of authority in the Dodd-Frank Act, which would apply a uniform fiduciary standard of conduct to both broker-dealers and investment advisers when providing personalized investment advice about securities to retail investors. SEC staff also recommended that the Commission consider whether certain regulations applicable to broker-dealers and investment advisers should be harmonized to add meaningful investor protection.

In light of the Commission's concerns over the potential economic impact of any rulemaking under Section 913 of the Dodd-Frank Act, Chairman Schapiro has asked a core team of economists from the Commission's Division of Risk, Strategy and Financial Innovation to study, among other things, data pertaining to the standards of conduct in place under the existing broker-dealer and investment adviser regulatory regimes to further inform the Commission. Since the Commission issued the study, this team of economists has been studying these issues, and staff has been reviewing public comments, meeting with interested parties to discuss their concerns, and requesting additional data to inform the staff's economic analysis. IM staff is participating in this process as appropriate.

- ***Study on Enhancing Investment Adviser Examinations.*** In January 2011, IM staff, with assistance from other divisions and offices, completed a study required by Section 914 of the Dodd-Frank Act that reviewed the need for enhanced examination resources for investment advisers that are registered with the Commission.[69] The staff report concluded that the Commission's examination program requires a stable and scalable source of funding, and it highlighted three options: (1) imposing user fees on SEC-registered investment advisers to fund their examinations; (2) authorizing one or more SROs to examine, subject to SEC oversight, all SEC-registered investment advisers; or (3) authorizing FINRA to examine dually registered investment advisers and broker-dealers for compliance with the Advisers Act.

Upcoming Challenges

IM staffing levels have remained flat over the past several years and currently are at the same level as they were FY 2005, despite the fact that the size and complexity of the investment management industry has grown tremendously since then. As a result, IM has staffing needs for both its core programs and new responsibilities stemming from a variety of Dodd-Frank Act provisions. In particular, IM would like to bolster its technical expertise in complex areas including derivatives, hedge funds, ETFs, asset-backed arrangements, credit analysis, portfolio management, securities analysis, mutual fund trading strategies, and investment company operations. IM also would like to enhance its oversight of money market funds and specialized

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

[69] The study is available at http://www.sec.gov/news/studies/2011/914studyfinal.pdf. A separate statement by Commissioner Walter is available at http://www.sec.gov/news/speech/2011/spch011911ebw.pdf.

products such as ETFs. The core program needs alone have put strain on existing resources and the Division continues to face challenges with allocating sufficient staff resources to additional responsibilities arising from the Dodd-Frank Act.

RISK, STRATEGY, AND FINANCIAL INNOVATION

Chief Economist and Director, Craig Lewis[70]

The Division of Risk, Strategy, and Financial Innovation (RSFI) was created as part of the agency's modernization initiative to share expertise and bring together critical data from across the agency. The Division was established in September 2009 to provide the Commission and its staff with sophisticated analysis that integrates economic, financial, and legal expertise. As part of this mandate, RSFI provides economic analyses as part of the Commission's rulemaking process, and supports its rule review, examination and enforcement programs with data-driven, risk-based analytical methods. It also oversees the Commission's TCR and interactive data programs. The Division has been the leader behind the agency's increased use of computerized risk analysis and inter- and intra-agency data sharing.

Economic Analysis

The Office of Economic Analysis (OEA) has the primary responsibility within the Division for providing economic analysis that supports rule making. OEA has 18 PhD economists that are dedicated to this activity. OEA is comprised of three offices that focus on particular areas of financial economics, which are similar to the areas covered by the three primary rule writing divisions: the Office of Corporation Finance, the Office of Markets, and the Office of Investments and Intermediaries.

The SEC has included cost-benefit analysis ("CBA") section in its rule releases since the early 1980s. RSFI participates in the rulemaking process by helping to develop the conceptual framing for and assisting in the subsequent writing of the its effects on the economic analysis sections. Where appropriate, the SEC "considers, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation" ("ECCF") when engaged in rulemaking.

Economic analysis of agency rules considers the key economic effects of the various alternatives that should be considered in developing regulations. Analysis of the likely economic effects of proposed rules, while critical to the rulemaking process, can be challenging. Certain costs or benefits may be difficult to quantify or value with precision, particularly those that are indirect or intangible. In light of recent court decisions, RSFI and the other divisions are examining improvements in the economic analysis the SEC employs in rulemaking. Although the existing procedures and policies are designed to provide a rigorous and transparent economic analysis, we are taking steps to improve this process so that future rules are consistent with best practices in economic analysis.

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70 Dr. Lewis joined the SEC as the Chief Economist and Director of Risk, Strategy and Financial Innovation in May 2011. http://www.sec.gov/news/press/2011/2011-114.htm .

Rulemaking Initiatives
In addition to assisting in the preparation of economic analyses related to rulemakings, RSFI conducts special research projects to inform the Commission about key aspects of rules, and performs independent research to investigate issues of relevance to the Commission. RSFI is assisting *w*ith several projects relating to market structure reform. RSFI also is conducting several concurrent analyses of smaller reporting and private companies to better understand the effects of the 12(g) registration requirement of 500 shareholders and $10 million in assets. This includes an investigation of non-reporting companies that publicly trade in the OTC markets. These analyses are being conducted in concert with the Division of Corporation Finance

RSFI contributed to rulemakings under the Dodd-Frank Act, including rulemakings for OTC derivatives and asset backed securities. In addition to rulemaking, the Dodd-Frank Act mandated a number of studies. RSFI has been engaged in a number of these studies, including:

- *Volcker Rule Study* – RSFI assisted SEC staff and staff from other Federal financial agencies on a Dodd-Frank-mandated, inter-agency study on effective implementation of the Volcker Rule.
- *Short Selling* – RSFI is completing the Dodd-Frank-mandated study of real time short sale position reporting and a voluntary pilot program in which new short-related marks would be reported to the Consolidated Tape. Concurrently, RSFI is conducting a second Dodd-Frank study of the state of short selling, with an emphasis on recent rule changes and fails to deliver. RSFI will also be assessing the impact of Rule 201 on the option markets, as required by that rule.
- *Extraterritoriality* – Dodd-Frank Act Section 929Y requires a study of the extent to which private rights of action under the antifraud provisions of the securities laws should be extended to conduct and transactions occurring outside the United States, including a study of the economic costs and benefits of extending a private right of action for transnational securities frauds.

Rulemaking Challenges
As noted, RSFI has had a significant role in many of the rules mandated by the Dodd-Frank Act. At the same time, the Division is committed to continuously improving economic analysis in Commission rulemakings and to better integrate RSI economists into the rulemaking process. While the Division is striving to fully comply with these increased demands, it faces challenges in its ability to do so given current resources.

Data-Driven Analysis and Risk Assessment
In addition to rulemaking, there are a number of data-driven responsibilities and initiatives that are specific to RSFI. The Division provides economic and statistical analysis to support all aspects of enforcement and litigation matters for Commission. RSFI has developed innovative software tools and cutting edge analytical methods that are designed to identify potential problem areas associated with investment managers that support the efforts of the Office of Compliance, Inspections, and Examinations.

The Division also oversees the TCR system and interactive data programs. RSFI is responsible for the operation, management, and governance of the system. RSFI is responsible for, among other things, generating data and statistics on how the system is operating, checking whether the system is being used properly, and helping with system development.

The interactive data program provides information contained in certain documents filed with the Commission in a structured format that makes the underlying data readily available for analysis. The Office of Interactive Data has a number of objectives that include, among others, promoting the use of interactive data, developing infrastructure and supporting rule writing to implement data tagging requirements. RSFI is responsible for producing web pages that support company filings on the EDGAR web site.

To improve efficiency, the Division has been reorganized to reassign staff that have expertise in data analysis and risk assessment into the newly formed Office of Quantitative Research (OQR), which will be responsible for building quantitative risk assessment models. This office has begun to build a data infrastructure to facilitate the development and support of analytics utilizing data that is collected by the Commission. OQR houses subject matter experts that include three PhDs with degrees in Economics and Mathematics and nine financial analysts that have significant industry experience

The Office of Litigation Support (OLS) provides economic and statistical analysis to support all aspects of enforcement and litigation matters for the Commission. OLS is comprised of subject-matter experts that include five PhD economists, three senior analysts that have significant industry experience, and two junior analysts.

<u>Litigation Support, Data Analysis, and Risk Assessment Initiatives</u>
The data analysis and risk assessment functions of RSFI contribute to initiatives and activities of divisions and offices across the SEC:

- *Enforcement cases*: RSFI staff designs and implements analytical tools to assist the Division of Enforcement to identify and quantify potential violations, including insider trading and front-running. RSFI staff is frequently consulted as expert witnesses in Commission actions.
- *Insider Trading Prosecutions* – Recently, RSFI staff provided support to Federal prosecutors in the successful prosecution of Raj Rajaratnam for insider trading. RSFI staff assisted these prosecutors with analyzing expert testimony and other documents proffered by the Rajaratnam defense. Additionally, federal prosecutors asked an RSFI staff member to serve as a testifying expert in the insider trading case against Winifred Jiau.
- *Supreme Court Briefs* – RSFI provided statistical expertise and arguments for the amicus brief filed by the United States in *Matrixx v. Siracusano*, in which the U.S. Supreme Court defined the role of statistical significance in securities litigation. In addition, RSFI staff provided expertise for the amicus brief filed in *Erica P. John Fund v. Halliburton*, on whether fraud plaintiffs need to prove loss causation to obtain class certification.
- *Regulated Entity Risk Models* – RSFI has developed and is continuously refining risk models to help OCIE efficiently direct exam resources among investment advisers, broker-dealers, and fund complexes in light of current trends and suspected abuses.

These models are designed to identify candidates for examination and focus resources mid-exam.

- *Analytical Tools and Expertise for Examination and Investigations* – RSFI has participated in exams and investigations, and developed tools, algorithms, and analytics that enhance the effectiveness of field teams at registrants. In particular, RSFI also provides guidance to OCIE staff during examinations of investment advisers that rely on quantitative or model driven strategies to help the examiners understand these strategies.
- *Dodd-Frank Data Collections* - RSFI will handle the new data collection responsibilities mandated by the Dodd-Frank Act, which include, among other items, credit default swap data and information about private fund advisers submitted using Form PF. For example, RSFI has been preparing for this responsibility by analyzing data provided by Depository Trust and Clearing Corporation (DTCC) on a voluntary basis for more than a year.
- *New Products* – RSFI has formed a working group to evaluate risks posed by new financial products. These products come to the working group's attention through a steady work flow of SRO rule changes and exemption requests, registrations for new issuances, its own research and through referral by SEC staff.

Challenges with Expanding Data Analytic and Risk Assessment Capabilities. RSFI would like to expand its capabilities to develop risk assessment models and to build a scalable data infrastructure to support risk-based initiatives across the SEC. Although the Division plans to pursue these objectives simultaneously and has existing employees with the necessary expertise to work on these projects, resource constraints inhibit progress and significantly slow the rate of innovation. For example, projects to develop risk assessment models to detect accounting fraud have been delayed due to resource constraints.

Research

RSFI economists conduct research on financial and economic subjects relevant to the SEC's mission for publication in peer-reviewed academic journals. This work includes researching and writing papers, and presenting these papers at conferences and similar academic forums for critique. Active participation in the research community helps inform its input into Commission policy and operations and ultimately helps make the SEC a more effective regulator.

Conclusion

While the SEC has made substantial progress in reforming its operations and increasing its efficiency, our efforts are ongoing. We will continue to further improve our internal operations, and will seek the resources needed to accomplish our core mission, implement the responsibilities given to us under the Dodd-Frank Act, and undertake seriously needed new technology initiatives. Investors and our markets deserve nothing less. We look forward to continuing to work closely with Congress, and we are happy to answer any questions you may have.