Testimony

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By

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Chairman Serrano, Ranking Member Emerson, Members of the Subcommittee, thank you for the opportunity to testify today on behalf of the Securities and Exchange Commission.

I am pleased to have the opportunity to discuss the Commission's role in the financial crisis and to discuss possible reforms to improve investor protection and confidence in our markets.

The last year has been a wrenching time for the investors whom the SEC is charged with protecting. Trillions of dollars in wealth have been destroyed during the economic downturn, and millions of Americans have seen their retirement nest eggs and college tuition funds shrink as a result. The economic crisis has challenged faith in our system of capital formation and allocation, a system that has proved over the long term to be the greatest for creating wealth the world has seen.

For an agency charged with protecting investors, maintaining fair, orderly and efficient markets, and facilitating capital formation, the events of the last year need to be understood, and the lessons learned so that we can restore investors' confidence in our markets. This means that the SEC needs to act promptly, decisively, and with resolve. This also means we must have a renewed commitment to protecting investors who provide the capital used to fund the productive enterprises that create jobs and wealth. While we have a tripartite mission at the SEC, investor protection is the essential piece from which the ability to promote capital formation and to maintain fair, orderly and efficient markets flows.

To that end, I've already announced several changes at the agency to restore confidence to investors and reiterate our commitment to investor protection.

One of my very first actions as Chairman has been to end the two-year "penalty pilot" program, which had required the Enforcement staff to obtain a special set of approvals from the Commission in cases involving civil monetary penalties against public companies as punishment for securities fraud. Enforcement staff had complained that the procedures unnecessarily delayed the prosecution of cases and discouraged the staff from either seeking a penalty or seeking an appropriately high penalty. At a time when the SEC needs to be sending a message that corporate wrongdoing will not be tolerated, and that the penalty for wrongdoing will be meaningful, the penalty pilot program sent the wrong message to the staff and to the public.

Another change I have implemented to bolster the SEC's Enforcement program is to provide for more rapid approval of formal orders of investigation that allow SEC staff to use the power of subpoenas to compel witness testimony and the production of documents. In investigations that require use of subpoena power, time is of the essence, and delay can be quite costly to the investigation. To ensure that subpoena power is available to the staff when needed, the agency has returned to a policy of timely consideration of formal orders by the seriatim process or, where appropriate, by a single Commissioner acting as duty officer.

In addition, I have recently hired Robert Khuzami, a longtime federal prosecutor who served as Chief of the Southern District of New York's Securities and Commodities Fraud Task Force, as the new Director of the Division of Enforcement. I will work with him on management reforms, including harnessing technology, improving risk assessment, and improving training and supervision for our line law enforcement personnel, so that we can maximize our resources to combat fraud and wrongdoing in our markets.As committed as we are to vigorous enforcement of the securities laws, we are also mindful that the complexity of 21st century markets and the varied nature of frauds and scams require that the sophistication and tools available to our Enforcement and Examination programs keep pace. Important questions have been raised concerning the agency's handling of tip or whistleblower information related to the activities of Beranrd Madoff. Former Chairman Cox asked the SEC Inspector General to look into what happened and report back to the Commission.

It is clear that, regardless of the ultimate findings of the Inspector General, the agency needs to improve its ability to process and pursue appropriately the more than 700,000 tips and referrals it receives annually. We have retained the Center for Enterprise Modernization to begin work immediately on a comprehensive review of internal procedures to evaluate tips, complaints, and referrals, with a goal of establishing a process that will more effectively identify valuable leads for potential enforcement action. In addition to these changes, it is essential that we work to improve our risk-based oversight of broker-dealers and investment advisers. Our Office of Compliance Inspections and Examinations, together with other agency staff, are presently working on an initiative to identify the key data points that would facilitate a risk-based oversight methodology and better allow the staff to identify and focus on firms presenting risk. OCIE is also continuing to focus on the training and expertise of examination staff -- and has formulated a plan to recruit additional individuals with experience in different facets of the industry -- to further build the knowledge base of our inspections program to conduct oversight of complex trading strategies and products that exist in our markets today. As well, the examination staffs of the SEC and FINRA are working together to identify ways that incipient frauds might be detected at an early stage.

I also plan to focus on the critical role played by rating agencies, and to improve the current ratings process. The SEC recently approved additional rules under our authority in the Credit Rating Agency Reform Act to address certain weaknesses in the ratings process. These rules were a first step in our continuing efforts to bring transparency and accountability to the ratings process, which plays a critical role in the market's pricing and allocation of capital. We are convening a roundtable next month of rating agencies, users of ratings, academics, and others to focus on what the commission can do to address the existing conflicts of interest in the rating agency model.

In other areas, the agency has worked hard in the last year in the current market crisis. In the area of accounting standards, the SEC staff completed a congressionally-mandated study of fair value accounting. The staff issued guidance to financial institutions so that they can give fuller disclosure to investors, particularly with respect to hard-to-value assets. We have also continued to work closely with the Financial Accounting Standards Board to deal with such issues as consolidation of off-balance sheet liabilities, the application of fair value standards to inactive markets, and the accounting treatment of bank support for money market funds.

In the area of combating false rumors and manipulative activity in the marketplace, the agency initiated examinations of the effectiveness of broker-dealers' and investment advisers' controls to prevent the spreading of false information. The SEC adopted a package of measures designed to strengthen investor protections against naked short selling, including rules requiring that fails from short sales be closed out in a significantly shorter time, eliminating the options market maker exception of Regulation SHO and expressly targeting fraud in short-selling transactions. As we move forward, the Commission will consider other steps necessary to eliminate manipulative and illegal activity in our markets, and limit market volatility.

In an effort towards bringing the unregulated world of credit default swaps into the sunlight, the agency has worked with private parties and its regulatory counterparts at the Commodity Futures Trading Commission and the Federal Reserve to facilitate the development and regulatory approval of central counterparties, clearance and settlement systems, and trading platforms for these products. I look forward to working with the Congress to ensure that these central clearinghouses, which are designed to mitigate systemic risk posed by the credit default swap market, are appropriately regulated.

Over the coming year, we will have an agenda that also focuses on issues of corporate governance, including proxy access, risk disclosure and the linkage between executive compensation and risk taking, money market fund regulation, retail investor protection and international cooperation.

SEC Resources

Few of the initiatives I have identified can be implemented with the SEC's existing resources. Most of this agenda will require additional funding, particularly to rebuild the agency's workforce and invest in new technologies.

With respect to the SEC's workforce, the agency suffered a significant decline in staffing levels a few years ago, due to several years of flat or declining budgets. Between 2005 and 2007, the agency lost 10 percent of its employees, a decline that inevitably affected all of the SEC's major programs. The agency's Division of Corporation Finance was reduced by 13 percent, its Examination staff fell by 7 percent, and the Enforcement workforce fell by 10 percent.

Yet as the SEC staff has declined, the securities markets grew dramatically. For example, since 2005 the number of investment advisers registered with the Commission has increased by 32 percent and their assets under management have jumped by over 70 percent to more than $40 trillion. The size, complexity, and geographical diversity of broker-dealer operations have expanded significantly, as exemplified by the 67 percent rise in the number of broker-dealer branch offices. There has been dramatic growth and complexity in structured financial products and credit derivatives in recent years. The amount of outstanding asset-backed securities more than doubled over the course of this decade to almost $2.5 trillion in 2007, and the issuance of collateralized debt obligations globally reached $521 billion in 2006, up from $157 billion just two years earlier. The SEC oversees more than 30,000 registrants including 12,000 public companies, 4,600 mutual funds, 11,300 investment advisers, 600 transfer agencies, and 5,500 broker dealers with a total staff of 3600 people.

In the context of such rapidly expanding markets, I believe the reductions in the SEC's staff seriously undermined the agency's ability to effectively oversee the markets and effectively pursue violations of the securities laws.

With support from this subcommittee, during the last two fiscal years the SEC was able to lift its hiring freeze and begin rebuilding its workforce. I also want to thank this subcommittee for providing additional funds to the SEC in the proposed appropriation for this fiscal year. As you know, the previous Administration's request for FY 2009 gave the SEC an increase of less than 1 percent over last year. But, the SEC will require a 5 percent increase just to sustain current staffing levels and provide cost-of-living and merit adjustments for staff. As a result, the previous Administration's request would have resulted in a cut of nearly 100 staff. The subcommittee's support for a 2009 appropriation of $943 million for the SEC will be enormously helpful as we work to reinvigorate and strengthen the agency in the wake of the last few difficult months. I am very grateful for that support. However, I have learned since coming to the agency several weeks ago that this funding level would still require the agency to make significant cuts in its current operations. I do not believe it would be wise for the SEC to retrench during such perilous times in our markets for investors.

For this reason, I have just submitted a reprogramming request to the subcommittee to use $17 million in the SEC's unspent prior year funds in fiscal year 2009. These are monies appropriated to the agency and obligated in past years, so this is not a request for the subcommittee to find new funds for the agency. Rather, the use of these prior year funds in 2009 would make a very big difference in allowing our important work of rebuilding investor confidence in the markets to continue unimpeded.

Then, I believe we must go further, if we hope to restore the SEC as a vigorous and effective regulator. The President is requesting a total of $1.026 billion for the agency in FY 2010, a 9 percent increase over the FY 2009 appropriation. This proposal demonstrates the Administration's firm resolve to strengthen oversight over our financial markets. It will fund an additional 50 staff for the SEC and enhance our ability to uncover and prosecute fraud and begin to build desperately needed technology.

Specifically, we plan to add staff to the SEC's Enforcement program to focus on pursuing tips, complaints, and other leads, increasing the resources the SEC can dedicate to frauds that citizens bring to our attention. The Examination program would also receive new positions to expand its inspections of credit rating agencies and to strengthen risk-based surveillance and examination oversight of investment advisers. Finally, I plan to increase the number of staff in our Office of Risk Assessment specifically dedicated to deepening our understanding of risk and incorporating risk assessment into all aspects of operations. The reprogramming request I mentioned earlier also would allow us to accelerate the hiring process for these staff, so we can bring them on board this fiscal year.

Although I believe expanding our workforce is a critically important step, I believe the agency must work smarter as well. That is why the President's request for FY 2010 also contains funds for additional investments in our information systems. These investments have dropped by two-thirds over the last four years, and as a result the SEC has a growing list of technology needs that have gone unfunded. With the additional IT funds provided under the President's Budget for FY 2010, I plan to focus on several key projects:

- First and foremost, we will use additional funds to enhance our systems for handling tips, complaints, and referrals. The SEC has a number of different processes to track this kind of information, but there is no central repository or system through which this information comes together to ensure it is handled consistently or appropriately. We are launching a comprehensive review of our current processes and investing over the next couple of years in new systems as needed. This is what the citizens who take the trouble to send in tips, as well as the investing public, demand and deserve.

- The SEC also plans to use additional technology funding to improve our ability to identify emerging risks to investors. We have many internal data repositories that have resulted from filings, examinations, investigations, economic research, and other ongoing activities. But we need better tools to mine this data, link it together, and combine it with data sources from outside the Commission to determine which firms or practices deserve a closer look.

- Finally, we would aim to complete the multi-year efforts to improve the case and exam management tools available to our enforcement and examination programs. These systems will give our senior managers better information on the mix of cases, investigations, and examinations, so they can apply resources swiftly to the continually evolving set of issues and problems in the markets. In addition, these tools will provide better support for line staff in these programs, so they can be more productive and better able to match the sophisticated systems used by the financial industry.

I want to thank you for your continued strong support for the SEC and its critical mission. By taking the steps I have outlined here—empowering enforcement to better respond to tips and other leads, enhancing our risk-based oversight of the markets, and leveraging technology—I believe we can successfully restore investor's confidence in both the SEC and in our nation's securities markets.

I would be happy to answer any questions you may have.