U.S. Securities and Exchange Commission

2006 Performance and Accountability Report

U.S. SECURITIES AND EXCHANGE COMMISSION

2006 Performance and Accountability Report
available on the web at
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2006

Performance and Accountability Report

MESSAGE FROM THE CHAIRMAN


Christopher Cox
Chairman

The prosperity of 300 million Americans and six billion people around the world relies on trustworthy U.S. capital markets. If you're a working American adult today, the odds are your savings are directly or indirectly invested in securities. Back in Joseph P. Kennedy's day, our first SEC Chairman could marvel that "one person in every ten" owned equities. But today, our financial markets encompass the investments, the hopes, and the dreams of half of all households. Some 57 million Americans now own stocks—and the median income for shareholders is a very middle-class $65,000.

The U.S. Securities and Exchange Commission serves you by working to secure the trust in our markets that undergirds our nation's continuing prosperity in an increasingly global economy. The level of trust in our markets has enormous economic consequences—affecting everything from the affordability of food, clothing, and shelter to the creation of new jobs, increases in wages, and the protection of our retirement security. This Performance and Accountability Report helps explain how the SEC works to sustain trust in our markets.

First and foremost, the SEC is a law enforcement agency. This follows from the SEC's threefold mission to protect investors, to ensure fair and orderly markets, and to promote capital formation. These highly complementary objectives each requires a tough cop on the beat. A high level of investor protection that comes with strong enforcement makes individuals and firms more likely to entrust their money to the U.S. capital markets. This helps produce fair and orderly markets, which in turn have lower transaction costs, thereby promoting capital formation. And healthy capital formation is an important ingredient of economic growth and job creation.

Americans can take pride in knowing that tough, predictable enforcement is not only an essential aspect of investor protection, but also an important contributor to our nation's economic health. This past year, an unprecedented high level of collaboration with our counterpart state and federal regulators and criminal authorities ensured that our mutual efforts were even more effective, and gave America's investors even more protection for their hard earned money. The Commission obtained near-record settlements, with penalties in the two largest accounting fraud cases totaling $1.2 billion. We took decisive action against the backdating of stock options, and moved to deregister a record number of firms that failed to provide investors with current quarterly and annual financial information. The SEC had a 10-0 record of trial court victories in fiscal 2006, its first perfect year in memory—a strong indication that the agency is bringing the right cases and getting solid results for investors and for taxpayers.

We've also worked closely with other state and federal regulators on another investor protection front: fraud aimed at senior citizens. The 75 million baby boomers start turning 60 this year. Over the next two decades, they'll do so at the rate of 10,000 every 24 hours. Following the Willie Sutton principle, fraudsters will go where the money is—threatening the life savings of older Americans who will be living longer and thus will be more than ever dependent upon returns on their investments. This SEC priority has been reflected in our community outreach efforts, in our investor education programs, in our examination program, and in the enforcement cases we bring.

In fiscal 2006, the SEC was extremely active on the rulemaking front, including finalizing a comprehensive improvement in the way executive compensation is disclosed. Also taking effect during fiscal 2006 were new rules that vastly simplified the U.S. public offering process—by broadening the scope of permissible communications both before and during an offering, liberalizing the rules for shelf registration statements, and completely eliminating the need to physically deliver final prospectuses in almost all cases. A new category of well-known seasoned issuers can now benefit from automatic shelf registration procedures.

We proposed e-proxy rules, to further advance our goal of tapping the enormous power of technology and the

Internet to simplify and improve disclosure. We approved stock exchange rules to improve market operations and took action to limit the non-investment uses of investment fund assets. We have worked closely with the Public Company Accounting Oversight Board to focus corporate internal control attention on areas creating the greatest risks for investors. We have nearly completed a collaborative effort with the Federal Reserve and other banking regulators to promulgate rules under the Gramm-Leach-Bliley Act concerning the role of banks in the securities brokerage business. And we're going to be relentless in seeing to it that the language of all of our regulations, and all of the public disclosure we administer, is plain English.

The SEC's Interactive Data initiative has paved the way for the imminent conversion of our public company disclosure regime to a global system of financial information exchange built on "smart data". In 2006, we awarded three separate contracts totaling $54 million to transform the agency's 1980s-vintage public company disclosure system from a form-based electronic filing cabinet to a dynamic real-time search tool with interactive capabilities.

We've also worked hard on every other area of the SEC's management during the past fiscal year. During the agency's first-ever financial statement audits in 2004 and 2005, our auditors—the U.S. Government Accountability Office—reported material weaknesses in the SEC's internal controls in the following areas: (1) recording and reporting of disgorgement and penalties, (2) information security, and (3) preparing financial statements and related disclosures. I am pleased to report that in 2006, each of those material weaknesses was eliminated. As a result, GAO was able to affirm that the financial statements included with this report were presented fairly in all material respects, in conformity with U.S. generally accepted accounting principles, with no material weaknesses in controls. Furthermore, we are pleased to confirm that the financial and performance data we present in this report are fundamentally complete, reliable, and conform to Office of Management and Budget guidance.

Perhaps the most consequential environmental development for the SEC during the past year was the quickening pace of bargaining in the marketplace for consolidation of the world's major exchanges. These competitive developments presage a world in which not only companies but investors can choose where to trade. In the future, every nation—including the U.S.—will discover that there are very real competitive limits to its ability to impose regulations. But this must not mean that regulatory arbitrage comes to carry the day. In order to ensure that the U.S. and other countries will not have to stand by and watch helplessly as their citizens' money is hijacked in a "race to the bottom" without sturdy standards to protect investors, the SEC has led the way in a global dialogue with our counterpart regulators in the major market centers of the world. In London, Paris, Brussels, Ottawa, Rome, Hong Kong, Sydney, Tokyo, New Delhi, Beijing, Mexico City, and scores of other capitals, we are working with national regulators to share market information and enforcement data that will better coordinate our efforts. As the SEC necessarily changes our regulatory focus from a mostly domestic U.S. equity market to a global market, we have aggressively collaborated with our counterpart regulators in other countries to minimize conflicting and duplicative regulation.

While global competition for investors' attentions and the lightning-fast pace of the information economy present new challenges to effective regulation and enforcement, the core principles of our 72-year-old mandate remain the same. We will continue to stand by, and for, investors. In today's complex markets, the SEC's mission is more important than ever.

Sincerely,

Chris Cox

Christopher Cox
Chairman
November 2006

MANAGEMENT'S DISCUSSION AND ANALYSIS

The Securities and Exchange Commission is the federal agency that administers the federal laws governing the U.S. securities markets. As such, the SEC plays a fundamental role in maintaining the integrity and vitality of America's markets and protecting the interests of investors. The following section outlines the agency's vision, mission, values, and goals, as presented in the SEC's five-year strategic plan, and provides management's discussion and analysis of the SEC's major accomplishments during fiscal year (FY) 2006, upcoming challenges, management controls, and financial highlights. This section also includes the results of the SEC's primary performance measures.

Vision

The Securities and Exchange Commission aims to be the standard against which federal agencies are measured. The SEC's vision is to strengthen the integrity and soundness of U.S. securities markets for the benefit of investors and other market participants, and to conduct its work in a manner that is as sophisticated, flexible, and dynamic as the securities markets it regulates.

Mission

The mission of the SEC is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.

Values

- *Integrity*
- *Accountability*
- *Fairness*
- *Resourcefulness*
- *Teamwork*
- *Commitment to Excellence*

GOALS

Enforce compliance with federal securities laws

The Commission seeks to detect problems in the securities markets, prevent and deter violations of federal securities laws, and alert investors to possible wrongdoing. When violations occur, the SEC aims to take prompt action to halt the misconduct, sanction wrongdoers effectively, and, where possible, return funds to harmed investors.

Promote healthy capital markets through an effective and flexible regulatory environment

The savings and investments of every American are dependent upon healthy capital markets. The Commission seeks to sustain an effective and flexible regulatory environment that will facilitate innovation, competition, and capital formation to ensure that our economy can continue to grow and create jobs for our nation's future. Enhancing the productivity of America is a key goal that the SEC works to achieve by increasing investor confidence in the capital markets.

Foster informed investment decision making

An educated investing public ultimately provides the best defense against fraud and costly mistakes. The Commission works to promote informed investment decisions through two main approaches: reviewing disclosures of companies and mutual funds to ensure that clear, complete, and accurate information is available to investors; and implementing a variety of investor education initiatives.

Maximize the use of SEC resources

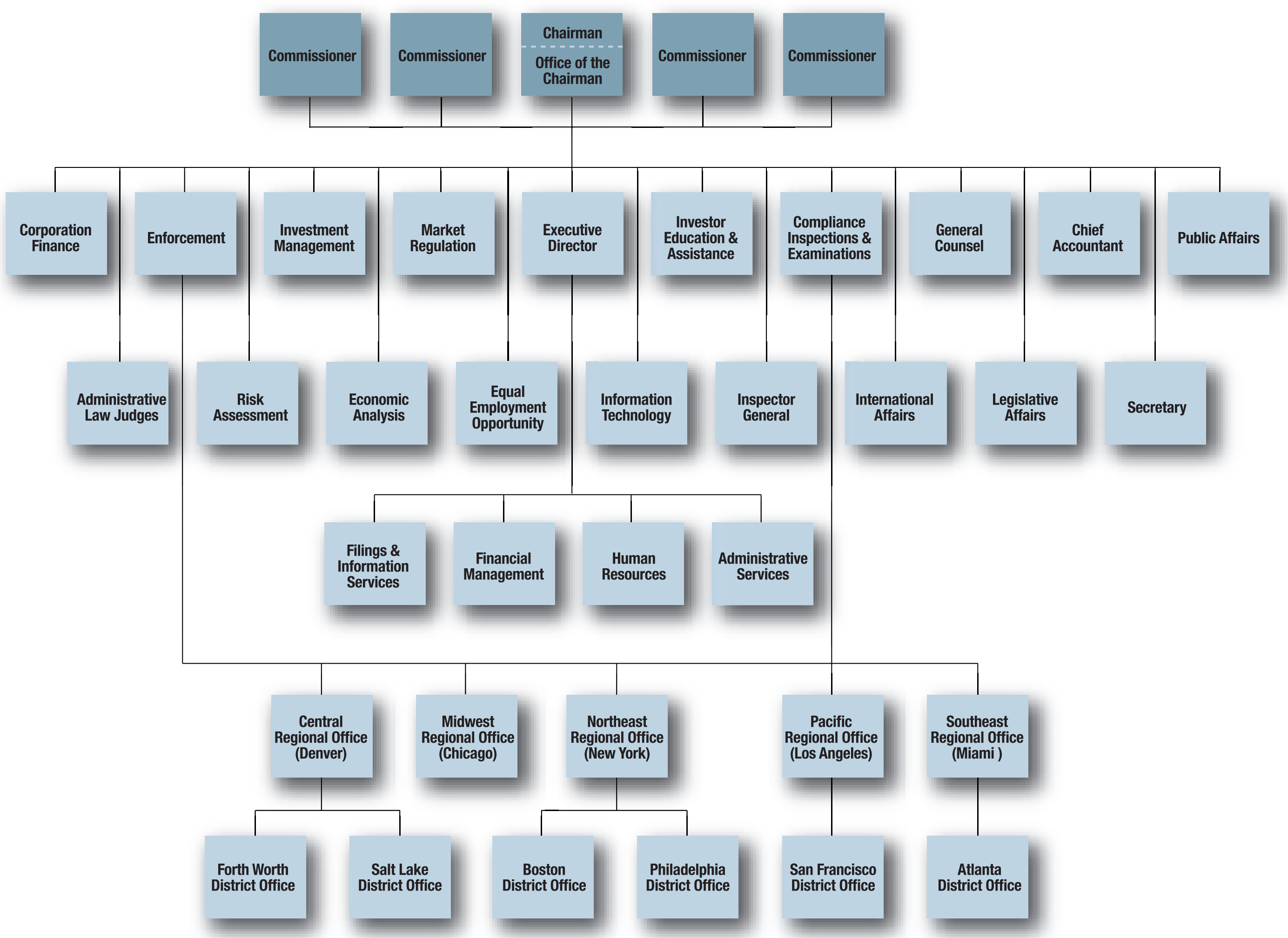
The investing public and the securities markets are best served by an efficient, well-managed, and proactive SEC. The Commission strives to improve its organizational effectiveness by making sound investments in human capital and new technologies, and by enhancing internal controls.

ORGANIZATIONAL STRUCTURE AND RESOURCES

The SEC is an independent federal agency established pursuant to the Securities Exchange Act of 1934. It is headed by a bipartisan five-member Commission, comprised of the Chairman and four Commissioners, who are appointed by the President and confirmed by the Senate. The Chairman serves as the chief executive officer. The SEC is organized into four main divisions: Corporation Finance, Market Regulation, Investment Management, and Enforcement. It also has 19 functional offices. The Commission's headquarters are in Washington, D.C., and it has 11 regional and district offices throughout the country. In FY 2006, SEC received authorized funding of $888 million. At September 30, 2006, the SEC had 3,590 staff, including 3,549 permanent staff and 41 temporary staff.

EXHIBIT 1.1

SEC Organization Chart



MAJOR ACCOMPLISHMENTS

FY 2006 was a year of notable achievement in all major program areas. The SEC's most significant accomplishments are discussed below.

Enforcing Compliance with the Securities Laws

The SEC continued to improve its efforts to ensure compliance with the federal securities laws through enforcement activities and the ongoing inspection of regulated entities.

Enforcement Program

In FY 2006, the SEC initiated 914 investigations, 218 civil proceedings, and 356 administrative proceedings, covering a wide range of issues. The major areas of enforcement activity were: corporate financial fraud, including abusive backdating of stock options; compliance failures at self-regulatory organizations and broker-dealers; and fraud related to mutual funds. The Commission prevailed in the great majority of the litigated enforcement actions decided by district courts and administrative law judges, and maintained a balanced distribution of cases across the core enforcement areas. The SEC's enforcement cases resulted in a total of more than $3.3 billion in disgorgement and penalties ordered against securities law violators during FY 2006. Whenever practical, the Commission seeks to return funds to harmed investors through the "fair fund" provision of the Sarbanes-Oxley Act, which allows the SEC to use penalties, in addition to disgorgement, to compensate injured investors for their losses. The following are some of the notable enforcement actions taken by the SEC in FY 2006.

Actions involving financial fraud

The Commission brought numerous cases involving financial fraud at public companies. In an effort to enhance consistency and transparency in the SEC's practice of sanctioning corporations that have committed fraud, in January 2006 the Commission unanimously issued a *Statement of the Securities and Exchange Commission Concerning Financial Penalties.* The statement provides a framework for decision making that is designed to ensure that the Commission can effectively sanction and deter corporate wrongdoing, while protecting the interests of shareholders who own public companies.

In its initial application of the new framework, the Commission settled an action against McAfee, Inc., alleging that the company improperly inflated its cumulative net revenues by $622 million between 1998 and 2000 and concealed the fraud from investors. McAfee consented to pay a $50 million civil penalty. In a parallel case, the Commission settled an action against Applix, Inc., alleging that the company improperly recognized $1.2 million in revenue in 2001 and 2002. The company agreed to cease and desist from future fraud violations and to take remedial measures to improve its internal controls; however, based on an analysis under the new framework, the Commission elected not to pursue monetary penalties.

Other significant financial fraud actions included cases against American International Group, Inc. (AIG), Fannie Mae, and Tyco International Ltd. The AIG case involved improper accounting relating to sham reinsurance transactions with GenRe Corporation. To resolve the SEC's claims, AIG agreed to pay $800 million in disgorgement and penalties, which will be returned to investors through a fair fund. The Commission's case against Fannie Mae, brought jointly with the Office of Federal Housing Enterprise Oversight (OFHEO), involved improper smoothing of earnings in violation of accounting rules. Fannie Mae agreed to pay a $350 million penalty in the SEC's case, which will be used to compensate harmed investors, and an additional $50 million to OFHEO. In the Tyco case, the Commission found that the company had utilized unlawful accounting practices in a scheme to overstate its reported financial results by $1 billion. The company agreed to pay a $50 million civil penalty.

The Commission also brought cases involving the fraudulent backdating of stock options. The SEC charged three senior officers of Comverse Technology, alleging that they engaged in a decade-long scheme to grant in-the-money stock options to themselves and others by backdating option grants to coincide with historically low closing prices of the company's common stock.

In a similar action, the Commission filed charges against three officers of Brocade Communications Systems, alleging that the company routinely backdated stock option grants to give employees favorably priced options without recording necessary compensation expenses. These actions concealed millions of dollars of expenses from investors and gave investors a false portrait of Brocade's financial condition. They also contributed to the restatements of hundreds of millions of dollars of Brocade's financial results from 1999 through 2004.

Actions involving self-regulatory organizations and broker-dealers

In FY 2006, the SEC brought several important cases involving self-regulatory organizations and broker-dealers. In a case against the Philadelphia Stock Exchange, the Commission found that the Exchange failed to enforce certain trading and order handling rules and provided inadequate surveillance measures for violations of equities trading rules. As a result of the SEC's action, the Exchange agreed to retain a third party auditor to conduct a comprehensive audit of its surveillance, examination, investigation, and disciplinary programs.

In a case involving misconduct in the $200 billion auction rate securities market, the Commission found that 15 broker-dealers, including Bear Stearns, Citigroup Global Markets, and Goldman Sachs, engaged in violative practices in the sale of auction rate securities. As a result of the Commission's action, the firms consented to pay more than $13 million in penalties.

In an illegal trading case, the Commission charged a former Merrill Lynch broker and former day traders and managers from A.B. Watley with participating in a fraudulent scheme to obtain confidential information about institutional customer order flow from major brokerage firms by compensating brokers with commission-generating trades and secret cash payments.

The SEC brought its first-ever enforcement action under the provisions of the USA Patriot Act that seek to protect the U.S. financial system from money laundering and terrorist financing. The Commission charged broker-dealer Crowell, Weedon with failing to comply with the record-keeping provisions of the Bank Secrecy Act, as amended by the USA Patriot Act, and the firm agreed to cease and desist from committing future violations.

Actions related to mutual funds

In FY 2006, the SEC continued to address abuses relating to the market timing of mutual funds. The Commission brought several notable cases against traders and brokers who carried out market timing schemes to the detriment of mutual fund shareholders. In a case against Millennium Partners, the Commission found that the firm fraudulently timed mutual funds by concealing its identity and thereby circumventing restrictions that the mutual funds imposed on market timing. The firm and four individuals together agreed to pay over $180 million in disgorgement and penalties, which will be used to compensate harmed investors.

In a related case, the SEC brought an action against Prudential Equity Group (formerly Prudential Securities), finding that brokers used deceptive market timing practices to conceal their identities, and those of their customers, to evade mutual funds' prospectus limitations on market timing. The Commission censured Prudential and ordered it to pay disgorgement of $270 million, which will be returned to the harmed mutual funds and fund shareholders. The Commission also filed suit against four former Prudential brokers for related conduct, and accepted the settlement of one previously sued broker.

The Commission brought an action against Bear Stearns charging the firm with securities fraud for facilitating unlawful late trading and deceptive market timing of mutual funds by its customers. The SEC ordered the firm to pay $160 million in disgorgement and a $90 million penalty, which will be paid into a fair fund to compensate the harmed mutual funds and fund shareholders.

Cross-border enforcement

In FY 2006, the SEC continued to cooperate with foreign authorities on cases with significant international components. The SEC encouraged other countries to adopt legislative reforms that are consistent with the minimum benchmark for international cooperation set by the International Organization of Securities Commissions (IOSCO), which has increased the SEC's ability to obtain information from a growing number of jurisdictions worldwide.

The SEC also participated in IOSCO's work to develop a multilateral approach for preserving and repatriating assets and supported a resolution adopted by IOSCO calling for jurisdictions to examine their legal framework and strive to develop mechanisms, including legislative reform, for freezing assets on behalf of a foreign regulator. The SEC also continued its efforts in specific cases to freeze and repatriate assets that were obtained in violation of U.S. securities laws and transferred abroad.

Information technology forensic program

During FY 2006, the Division of Enforcement implemented a new forensic lab equipped with state-of-the-art equipment and software. The lab allows Enforcement to retrieve data stored on electronic devices like personal computers, servers and laptops. Since such data is volatile, subject to damage, and requires special processing and handling, the forensic lab has created special protocols that are essential to the preservation and authentication of this data. Enforcement has also trained a team of examiners who are able to perform forensic-related activities such as recovering deleted data and analyzing email and other relevant artifacts. The forensics program has fundamentally transformed Enforcement's ability to receive, process, and analyze electronic storage devices.

EXHIBIT 1.2

Distribution of Cases Across Core Enforcement Areas

DESCRIPTION: Effective deterrence of securities fraud requires that the cases filed by the SEC have adequate reach across all core enforcement program areas. The mix and types of cases change from year to year based upon the conditions of the markets and the changes in financial instruments being used. The SEC's enforcement program seeks to maintain a presence and depth so that no single area dominates its case mix, nor is underrepresented. This measure evaluates whether the Commission maintains an effective distribution of cases so that no category exceeds 40 percent of the total.

	PERCENTAGE OF CASES			
CORE ENFORCEMENT PROGRAM AREAS	FY03	FY04	FY05	FY06
Financial Disclosure	29%	28%	29%	24%
Investment Advisers/ Investment Companies	11	14	16	16
Broker-Dealers	20	22	15	13
Securities Offerings	16	15	9	11
Insider Trading	7	7	8	8
Market Manipulation	5	6	7	5
Other	12	8	16	23
Total	100%	100%	100%	100%

Examination Program

The SEC's examination program works to detect fraud and other possible violations of the federal securities laws, foster compliance with these laws, and inform the Commission and its staff of compliance issues. The Office of Compliance Inspections and Examinations (OCIE) uses risk-based methodologies to focus resources on those activities that could pose the greatest risk to investors and the integrity of the markets. In FY 2006, OCIE continued to refine and implement risk-assessment techniques to identify and focus on firms and activities that present the greatest compliance risk to investors. OCIE also explored new technologies to facilitate the conduct of examinations and the review of large volumes of data, and implemented an automated system to track examinations in order to improve coordination of examinations and prevent duplication. Examination staff continued and expanded cooperative examination initiatives with domestic and foreign regulators.

OCIE substantially enhanced training for examiners with respect to new rules applicable to securities firms, and on current trends in the securities industry, including broker-dealers providing investment advisory services and the activities of hedge fund advisers.

OCIE also initiated a pilot program for monitoring the largest asset management and broker-dealer firms, took steps to make its examination process more transparent to firms under examination, and created a "Hotline" to receive any complaints or concerns from firms under examination.

The staff of OCIE and the Division of Investment Management jointly continued to conduct the CCOutreach Program, which seeks to encourage strong industry compliance practices by providing information to adviser and mutual fund compliance professionals. The staff conducted a national seminar at SEC headquarters that was attended by approximately 500 adviser and fund compliance officers and transmitted via web cast to many more. The seminar covered a range of topics that are critical to compliance officers in administering their firms' compliance programs. In addition, during the summer of FY 2006, examination staff from the SEC's field offices conducted 27 regional seminars attended by about 1,750 adviser and fund chief compliance officers. The primary focus of discussions during these regional seminars was the identification of compliance risks, which is the starting point for constructing a comprehensive and effective compliance program.

Examinations of investment advisers and investment companies

The examination staff completed routine inspections of 650 advisers with higher risk profiles and 328 lower-risk advisers that were randomly selected from lower-risk firms. These routine inspections focused on firms' compliance programs and areas where compliance procedures were found to be weak or non-existent. Examiners also conducted 368 inspections of advisers that either appeared to have specific issues needing further scrutiny or that were part of a risk-targeted examination sweep. For example, OCIE initiated a sweep to review procedures that firms use to prevent identity theft.

Advisers inspected had assets under management of $10.9 trillion, which was about 40 percent of the total assets under management of all registered advisers at the beginning of FY 2006. As part of these inspections, staff examined 344 registered fund groups, including mutual fund transfer agents, and reviewed about 750 privately-offered investment funds. Overall, 80 percent of examinations revealed some type of deficiency or control weakness, and 6 percent of adviser and registered fund inspections were referred to enforcement staff for further review. Importantly, most examinations resulted in corrective action and improved compliance or risk management by the firms examined.

EXHIBIT 1.3

Investment Advisers and Investment Companies Examined

DESCRIPTION: To conduct oversight of investment companies and advisers, the staff conducts a risk-based program of routine examinations, cause inspections to follow up on tips and complaints, and special inspections to probe emerging risk areas. Growth in the industry and severe compliance issues caused changes in the SEC's oversight of investment companies and advisers in 2003–2004.

	FY02	FY03	FY04	FY05	FY06
Investment Advisers	1,570	1,556	1,543	1,530	1,346
Investment Companies	304	318	783	582	344

Examinations of investment advisers and investment companies completed in FY 2006 are lower than in previous years, for a variety of reasons. These include: an increase in the complexity of registrants' operations, including the need to review the activities of private funds in conjunction with examination of the funds' advisers (e.g., in FY 2006, about 750 privately-offered investment funds were also reviewed); a substantial increase in the time needed during routine examinations to evaluate the effectiveness of the compliance programs that advisers and funds were required to maintain beginning in FY 2005; an increase in examination scope in order to review advisers' and funds' compliance with other new regulatory requirements; a decrease in the number of targeted special examinations conducted (which are generally of shorter duration than routine exams); the dedication of staff resources to new proactive initiatives designed to improve compliance, including CCOutreach and the monitoring of large advisory groups; and a decrease in resources.

Examinations of broker-dealers

In its FY 2006 examinations of broker-dealers, OCIE focused on areas of significant compliance and financial risks, including: sales practices to retail investors, including the suitability of various products; business continuity planning; anti-money laundering; suitability focusing on various products; misuse of non-public information concerning trading activities of institutional investors; execution practices in equities and debt, including mark-ups; compliance with net capital and customer reserve obligations; and branch office supervision. OCIE conducted special risk-targeted examinations on topics such as sales and marketing to senior citizens, short sales, day trading, sales of periodic payment plans, and fee-based accounts, among other areas. Special examinations were also conducted of large firms' internal controls.

Examiners found some type of deficiency or control weakness in about 90 percent of inspections, and about 25 percent of the exams resulted in referrals to the enforcement staff or a self-regulatory organization for further review. Importantly, most examinations resulted in remedial action and improvements in the firms' compliance or risk management programs.

Examinations of self-regulatory organizations and the Public Company Accounting Oversight Board

OCIE conducted risk-based and routine inspections of the self-regulatory organizations' surveillance, examination, disciplinary, arbitration, customer communication, and listing programs. These inspections resulted in improvements in regulatory programs conducted by the securities exchanges. Together with the SEC's Office of the Chief Accountant, OCIE also completed the first inspection of the Public Company Accounting Oversight Board (PCAOB).

Improving Disclosure for Investors

The SEC worked to improve the quality, reliability, and timeliness of disclosure to investors by undertaking the following actions.

Enhanced executive compensation disclosure. The SEC adopted far-reaching amendments to the disclosure requirements relating to executive and director compensation, related party transactions, director independence, and other corporate governance matters. The amendments require companies to present this information in plain English and in a tabular format useful to shareholders, analysts, journalists, and the investing public. For the first time, companies must present all elements of compensation as a single total dollar amount for each executive. Companies must also discuss and analyze their compensation policies and decisions. In addition, companies must disclose certain compensation information on a real-time basis in current reports on Form 8-K.

Global accounting standards. Last year, the SEC staff published a "roadmap" of the milestones necessary to permit foreign private issuers to file financial statements prepared under International Financial Reporting Standards (IFRS), without reconciling them to U.S. generally accepted accounting principles. The roadmap involves, among other things, a detailed analysis of the faithfulness and consistency of the application, interpretation, and enforcement of IFRS in financial statements across companies and jurisdictions, and continued progress in the convergence work now being conducted by the International Accounting Standards Board and the Financial Accounting Standards Board. The SEC staff has been working with other regulators, including through IOSCO and the Committee of European Securities Regulators (CESR), to help reach some of these milestones. For example, the SEC staff and CESR finalized a work plan in 2006 to share information about IFRS implementation.

Disclosure review. The Divisions of Corporation Finance and Investment Management continue to improve their disclosure review programs to comply with the review requirements of the Sarbanes-Oxley Act of 2002. In FY 2006, the SEC staff reviewed the filings of 4,485 public companies and 4,151 mutual funds.

EXHIBIT 1.4

Percentage of Reporting Companies and Investment Companies with Disclosures Reviewed by the SEC

DESCRIPTION: The Sarbanes-Oxley Act requires that the SEC review the disclosures of all reporting companies and investment company portfolios at least once every three years. These reviews help improve the information available to investors and can uncover serious violations of the securities laws.

	FY03	FY04	FY05	FY06
Corporations	23%	22%	50%	33%
Investment Companies	10%	54%	37%	36%

FY 2005 marked the completion of the first three-year cycle under the Sarbanes-Oxley Act; and in FY 2006, the SEC remained on track to review every reporting company and investment company at least once every three years. The Division of Corporation Finance continued to release filing review correspondence through the EDGAR system in order to increase the transparency of its review process.

Given the increased global nature of public company operations, in its review of public company filings, the Division of Corporation Finance considered whether each company's disclosure indicated material contacts with countries the State Department has identified as sponsors of terrorism and sought enhanced disclosure as appropriate.

Interactive data. In April 2005, the Commission established a voluntary program to permit registrants to submit required financial disclosures using eXtensible Business Reporting Language (XBRL). The interactive format transforms this financial data so that investors, analysts, and other market participants, as well as the SEC itself, can analyze and personalize the information in ways best suited for their purposes. It will be easier for the public to retrieve financial ratios, written disclosures, mutual fund expenses, and other information critical to their investments.

In January 2006, the SEC offered companies expedited reviews of their registration statements and annual reports if they submit their disclosures using XBRL and share their experiences with the agency. So far, more than 20 major companies are now participating in the program. In June 2006, the Commission also conducted the first in a series of interactive data roundtable discussions to explore ways to further expand the use of technologies like XBRL.

EXHIBIT 1.5

Percentage of Forms and Submissions Filed Electronically and in a Structured Format

DESCRIPTION: The SEC is continuing to emphasize electronic filing to make information available to the public in a format that can be easily obtained and analyzed. The SEC currently has over 100 forms that must be filed with the agency, which annually generate hundreds of thousands of filings. The agency is redesigning its form filing capabilities to rely on more structured formats (e.g., information is captured in a comma delimited, XML, XBRL, or other format). This measure gauges the percentage of forms that are available to be filed in a structured format and the percentage of resulting filings that are received in the structured format. In addition, this measure identifies the overall percentage of forms that are in electronic format and the overall percentage of resulting filings that are received electronically by the SEC.

	FY03	FY04	FY05	FY06
Forms				
Structured format	4%	4%	5%	8%
Another electronic format	68%	68%	67%	62%
Total percentage in electronic format	72%	72%	72%	70%
Filings Received				
Structured format	21%	36%	35%	35%
Another electronic format	55%	52%	54%	55%
Total percentage in electronic format	76%	88%	89%	90%

The percentage of the forms that are electronic declined slightly in FY 2006; however, that was due to consolidation or elimination of a small number of electronic forms rather than an increase in paper forms. Meanwhile, the overall number of electronic filings versus paper filings continued to increase. The proportion of forms filed with the SEC that are in structured formats such as XBRL increased in FY 2006. However, the overall number of structured filings declined slightly in FY 2005 and 2006, due to various market dynamics that resulted in fewer being filed in those years. The SEC will continue to work toward its goal of substantially increasing the percentage of forms and submissions in structured format, as well as converting 100 percent of all filings and submissions into electronic format.

Promoting an Effective and Flexible Regulatory Environment

Through a variety of rulemaking and other initiatives, the SEC continued to modernize and refine its regulations in order to facilitate innovation and competition while protecting the interests of investors.

Implementation of Section 404 internal control requirements. The SEC and the Public Company Accounting Oversight Board hosted a roundtable discussion on second-year experiences with implementing the internal control requirements under Section 404 of the Sarbanes-Oxley Act of 2002. Following the roundtable, the SEC announced that it would develop and issue guidance for management to follow in assessing internal controls over financial reporting and would oversee the PCAOB's revision of its related audit standard, as well as the PCAOB's implementation of those revisions. The SEC also announced that, in order for companies and auditors to have the benefit of these efforts, it would delay required implementation of the internal control requirements for certain smaller public companies.

Evaluated the needs of smaller companies. The SEC began its review of the recommendations of the SEC Advisory Committee on Smaller Public Companies. The Advisory Committee's recommendations relate to a broad range of topics, including capital formation, on-going corporate reporting, and internal control over financial reporting. Consistent with a recommendation of the Advisory Committee, the SEC delayed implementation of the management reports required under Section 404 of the Sarbanes-Oxley Act until the 2007 fiscal year, and delayed the auditor attestation requirement for certain foreign private issuers with market capitalization between $75 million and $700 million until the 2007 fiscal year. The SEC also proposed delaying the auditor attestation requirement until the 2008 fiscal year for certain public companies with less than $75 million in market capitalization.

Interpretive release on soft dollars. The SEC issued a final interpretive release relating to the scope of the soft dollar safe harbor under Section 28(e) of the Securities Exchange Act of 1934. The release clarifies the eligibility criteria for brokerage and research services and the circumstances under which money managers may use client commissions to pay for those services. The release also provides guidance to money managers and broker-dealers on the arrangements that managers may use to obtain brokerage and research services under the safe harbor.

Equal payments in tender offers. The SEC proposed amendments to its tender offer "best-price rule" to adapt the rule to recent judicial developments and reinforce its basic purpose—ensuring that all shareholders who tender their securities in an offer receive the same consideration. The Commission adopted final rule amendments in October 2006.

Deregistration by foreign issuers. In response to the concerns of foreign companies, the SEC proposed rule changes that would make it easier for foreign companies with little U.S. market interest to terminate their reporting obligations. In recognition of the information needs of investors, the Commission also proposed rules that would provide U.S. investors with ready access through the Internet to material information about a foreign company that maintains its reporting exemption after it has ceased filing reports with the SEC.

Proposal for investors to receive proxy statements over the Internet. The Commission proposed rules that would allow companies to use the Internet to satisfy the delivery requirements for proxy materials. Shareholders would continue to have the option of receiving paper copies. The proposed rules could substantially reduce the expense of complying with the proxy rules, provide investors with a user-friendly means of obtaining and reviewing proxy materials, and provide persons other than the company with a more cost-effective means to undertake their own proxy solicitations.

Increased flexibility and transparency for funds of funds. The SEC adopted rules that expand current Investment Company Act exemptions relating to certain fund of funds arrangements, including a rule to allow funds to sweep their cash overnight into money market funds. To increase the transparency of expenses in these arrangements, the SEC adopted requirements that a fund that invests in other funds disclose in its fee table the cumulative amount of expenses charged by the fund and the funds in which it invests. These initiatives removed unnecessary regulatory burdens, while maintaining investor protections.

Investment adviser/broker-dealer study. The SEC awarded a contract to conduct factual research and analysis for a major study comparing how the different regulatory systems that apply to broker-dealers and investment advisers affect individual investors. Broker-dealers are regulated under the Securities Exchange Act of 1934, while investment advisers are under the authority of the Investment Advisers Act of 1940. The study will examine how these different regimes affect investors and assist the Commission in assessing the current legal and regulatory environment. The study will involve collecting, categorizing, and analyzing data from a variety of sources, including marketing, sales, and delivery data about the financial products, accounts, programs, and services offered to individual investors.

Regulation B. Since the enactment of the Gramm-Leach-Bliley Act in 1999, the SEC has extended the effective date for the bank broker provisions several times. Most recently, the Commission granted banks a temporary exemption from broker registration until January 2007. In June 2004, the Commission proposed Regulation B, which would implement the bank securities activities exceptions from the definition of "broker" in the Securities Exchange Act of 1934. In 2006, the Chairman met on a regular basis with senior representatives from the federal banking agencies to discuss ways to implement the bank broker exceptions in a way that will support investor protection while minimizing compliance costs and disruption with respect to banks' existing business practices. In October 2006, new legislation was signed that provides that the SEC and the Board of Governors of the Federal Reserve System must jointly propose rules implementing the bank broker exceptions within 180 days.

Facilitating Changes in Market Structure and Cross-Border Cooperation

Approval of NASDAQ exchange application. In January 2006, the SEC approved the Nasdaq Stock Market's application to become a registered national securities exchange. The conditions to its operating as an exchange included Nasdaq's individual participation in various national market system plans; the implementation of certain regulatory plans that will permit Nasdaq to fulfill its self-regulatory obligations; and the ability of the NASD, which has controlled Nasdaq since 1971, to satisfy its own statutory obligations independently from Nasdaq. Nasdaq is currently working to fulfill these conditions.

NYSE hybrid market proposal. The SEC approved the New York Stock Exchange's proposal to alter fundamentally its market structure by converting from a traditional floor-based auction market with limited automated access to liquidity, to a largely automated market with some manual order interaction. The NYSE plans to implement this "Hybrid Market" structure in five phases by the end of 2006.

NYSE/Archipelago merger. The SEC approved rule proposals from the NYSE and the Pacific Exchange (now known as NYSE Arca) necessary to permit a merger to combine their businesses under one publicly-traded holding company. The merger was completed, and the NYSE Group common stock began trading in March 2006. As a result of the transaction, NYSE Group owns two registered exchanges, the New York Stock Exchange and NYSE Arca. Through this transaction, the NYSE demutualized, separating equity ownership in the NYSE from trading privileges on the exchange.

Implementation of Regulation NMS. The SEC addressed important issues of equity market structure as the individual markets transformed to meet the desires of their customers for more efficient, automated trading and to comply with automated trading provisions of Regulation NMS. Regulation NMS sets the terms for competing markets to access and interact with each other and is intended to strengthen competition in the national market system. Nine of the ten national securities exchanges are either adopting new automated trading systems or substantially modifying their existing trading systems to respond to these competitive challenges. The SEC worked closely with the exchanges and securities industry throughout FY 2006 to promote a non-disruptive and cost-effective rollout of the new trading systems and implementation of Regulation NMS.

Cross-border exchange affiliations. The SEC has undertaken to articulate its preliminary views on the potential regulatory implications arising from an affiliation between U.S. and non-U.S. securities exchanges. In addition, the SEC has initiated a dialogue to discuss the regulatory aspects of potential cross-border exchange mergers with its regulatory counterparts in other jurisdictions. During the past several months, Nasdaq has acquired a 25 percent stake in the London Stock Exchange, and the NYSE has entered into a combination agreement with Euronext, which includes the U.K. derivatives exchange Liffe. The SEC and the College of Euronext Regulators are currently taking the necessary steps regarding the regulatory approval processes for the proposed combination of NYSE and Euronext.

Oversight of globally active firms and exchanges. The SEC entered into a Memorandum of Understanding with the U.K. Financial Services Authority to increase cooperation in market oversight and supervision. This comprehensive arrangement created a framework for regulatory consultation and the exchange of supervisory information with respect to financial firms and investment banking groups that operate both in the United States and the United Kingdom. The MOU promotes cooperation on inspections of dually registered firms in order to use resources efficiently and minimize duplicative efforts.

Interagency statement on sound practices concerning complex structured finance activities. In May 2006, the SEC, together with the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation, requested comment on a revised statement to provide guidance that may help financial institutions identify, manage, and address the heightened reputational and legal risks that may arise from certain complex structured finance transactions. The agencies focused on those transactions that may pose heightened levels of legal or reputational risk to different financial institutions.

SEC technical assistance program. The SEC drew record numbers of regulators from emerging and developed markets to the Commission's International Institute for Securities Market Development in April 2006, including 147 delegates from 70 countries. Additionally, securities commissions and stock exchanges are increasingly requesting the expertise and experience of SEC staff in dealing with insider trading, market manipulation, corporate governance, inspections and compliance, and a host of other market development and enforcement issues. Vietnam, Kuwait, and Iraq sought the SEC's assistance in drafting new securities laws. The SEC staff also conducted or substantially participated in regional or bilateral training programs in China, India, Malaysia, Philippines, Thailand, Vietnam, Ecuador, Peru, Trinidad and Tobago, Bahrain, and Saudi Arabia.

Bilateral regulatory dialogues. The SEC also enhanced collaboration on regulatory issues by entering into dialogues with the China Securities Regulatory Commission, the Japan Financial Services Agency, and the Korea Financial Supervisory Commission. The objectives of the dialogues are to identify and discuss common regulatory concerns in the context of promoting converged approaches to regulatory issues, and to improve cooperation and the exchange of information in cross-border securities enforcement matters.

Focusing on the Individual Investor

Protecting retirees and elderly investors. In 2006, at Chairman Cox's direction, the SEC launched an initiative to focus on the protection of senior investors from investment fraud and the sales of unsuitable securities. The SEC held the first-ever "Seniors Summit" among federal and state regulators and other interested groups to examine how regulators and others can better coordinate efforts to protect older Americans from investment fraud and abusive sales practices. To further this effort, the SEC partnered with the North American Securities Administrators Association in a three-part strategy involving investor education, targeted examinations, and enforcement actions. The SEC's Office of Investor Education and Assistance (OIEA) and staff in regional/district offices participated in numerous educational events targeted to seniors, and issued numerous investor alerts and publications aimed at senior investors. OIEA created a special web page to provide seniors and their caregivers with high-quality, unbiased investor education materials with information on investments commonly marketed to seniors, such as variable annuities, equity-indexed annuities, and promissory notes, as well as tips for detecting and avoiding fraud. Examination staff in OCIE launched an examination sweep of more than 65 broker-dealers and advisers that sponsor "free lunch" sales seminars targeted to seniors, along with state securities regulators and the NASD and the New York Stock Exchange. The SEC has already brought several enforcement actions against fraudsters who would prey on seniors.

Plain English—the new language of the SEC. In his testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Chairman Cox identified plain English as one of four key initiatives to improve the quality and usefulness of disclosure for individual investors. As discussed above, the SEC has adopted rule changes to improve the quality of executive compensation disclosure and require that companies present that disclosure in plain English, rather than boilerplate or legalese.

Searchable text on EDGAR. In FY 2006, the SEC enhanced the search capabilities of EDGAR by adding a full-text search feature that allows the public to search the complete text of EDGAR filings from the past two years on the SEC website. Users now can search by any keyword or concept, within specified date ranges, form types, or company names. The public also now will be able to retrieve mutual fund filings more easily by fund or share class.

Point of sale disclosure. As part of a continuing effort to strengthen disclosures to investors, the staff continued to gather information to help the Commission finalize its point of sale disclosure proposal. Unlike the confirmation, which comes after the trade is executed, the "point of sale" document would be delivered to investors at the time they are making their investment decisions. The proposal would require broker-dealers to disclose to their customers the costs and conflicts of interest that arise from the distribution of mutual funds, variable annuities, and 529 college savings plans. In light of comments received, the staff is considering how best to incorporate new technologies into disclosure requirements in a way that will benefit a wide range of retail investors.

Managing the SEC More Effectively

Improved budget process. In July, 2006 the SEC implemented the initial phase of the Budget and Program Performance Analysis System (BPPAS), an activity-based costing and performance-based budgeting system, which will significantly enhance the SEC's capabilities to report and analyze its financial planning, budgeting, cost-assignment, and operations performance. BPPAS is an important tool for managers and staff, providing a detailed picture of the Commission's operations and effectiveness. In addition, BPPAS has further strengthened the budget process by providing more auditable and transparent budget formulation and execution processes. The SEC also applied additional resources to its budget processes and enhanced its long-range planning in the administrative and facilities areas.

Strengthened internal controls. The SEC made substantial progress in strengthening its agency-wide internal controls. The agency resolved each of the three material weaknesses identified in prior year financial statement audits, and laid the groundwork for further improvements in FY 2007. The SEC's planned actions in these areas are designed to address the reportable conditions identified by the Government Accountability Office (GAO) during its FY 2006 financial audit. For a more complete discussion of the SEC's ongoing efforts to strengthen internal controls, see the *Challenges* and *Management Controls and Compliance with Laws and Regulations* sections.

Information technology investments. The SEC continued to build upon a voluntary program initiated in FY 2005 that allows registrants to use eXtensible Business Reporting Language in their financial disclosure filings. In early 2006, an interactive data test group was launched to explore how new Internet-based reporting technologies can improve the financial reporting process for investors, financial intermediaries, the SEC, and companies themselves. The pilot program enables participant companies to determine the benefits of using interactive data and provide feedback to the SEC, and enables investors and analysts to assess new technologies for analyzing interactive data reports submitted to the SEC in XBRL format.

The SEC's examination program spends a great deal of time analyzing the quantitative information obtained from regulated entities during the course of inspections, in areas such as trading activity, securities holdings, and other details of the business conducted. The new prototype Data Analysis and Reporting Tool (DART) provides OCIE automated analysis capabilities that will enable examiners to more quickly identify compliance issues and conduct inspections in a more efficient and timely manner.

During FY 2006, the SEC initiated several projects to increase productivity; measure, analyze and improve organizational performance; and improve the quality of services supporting the Commission's divisions and offices. These initiatives included upgrading and automating back-office operations in the areas of capital planning and investment control; budget formulation and financial management; and procurement and contracting. The new Strategic Acquisition Management (SAM) system will provide accurate and timely procurement information that will help the SEC reduce costs, leverage its spending power, manage expenditures, and measure supplier performance.

EXHIBIT 1.6

Milestones for Major IT Projects

	FY05	FY06
Modify EDGAR to accommodate interactive data in XBRL format for financial reports	Initiated	In Progress
Transition EDGAR system management to new contract	Initiated	In Progress
Enhance SEC.gov to improve EDGAR data searches and accessibility for investors	Initiated	In Progress
Image backlog of paper-based discovery documents	In Progress	In Progress
Provide fully automated processing of options trade records in support of enforcement investigations	In Progress	Completed
Redesign the enforcement case management system to improve management of penalties and disgorgement	Initiated	In Progress
Upgrade analytical tools available to examiners	Initiated	In Progress
Implement new systems to support expansion of telework	In Progress	Completed
Migrate to alternate data center	Completed	
Certify and accredit major systems for information security risk	In Progress	Completed
Implement Homeland Security Presidential Directive 12 for personnel identity verification and access control	Initiated	In Progress

Expanded telework program. The SEC has dramatically increased its telework participation rate in the past year. Currently, 34 percent of SEC employees telework. This statistic is particularly notable since the SEC is one of the few federal agencies that do not exclude certain job functions or groups of employees from telework. In FY 2006 the SEC purchased and deployed new technology that allows employees to access their files via the Internet at any time or location, thereby facilitating more telework without compromising the security of the SEC's information. Also, the SEC continued its pilot "virtual workforce" project in the Division of Corporation Finance, in which an initial group of 10 employees works from home full-time. The SEC is exploring options for expanding the program to other parts of the agency.

Completed building projects. The Chairman successfully restructured the FY 2006 budget to cover all of the build-out costs related to the agency's new Washington, New York, and Boston offices up front, rather than spreading them out over several years. As a result, the SEC avoided spending millions of dollars on unnecessary financing costs. These three construction projects were completed in spring 2006, and the Office of Administrative Services successfully moved nearly 1,400 staff into the new facilities.

CHALLENGES

The SEC undertook a variety of actions in FY 2006 to address the challenges highlighted in last year's Performance and Accountability Report, as well as new issues that have emerged. The following section discusses the SEC's key challenges and the steps the agency is taking to meet them.

Strengthening Internal Controls

The SEC aims to set the standard for internal controls against which federal agencies are measured. In FY 2006, the agency resolved each of the three material weaknesses identified by the Government Accountability Office in their financial audits for FY 2004 and FY 2005. The SEC will continue to evaluate and strengthen its controls in all operational areas during FY 2007, to ensure reliability of financial reporting, soundness of its operations, and public confidence in the agency's mission.

Financial statement preparation process. The SEC made substantial improvements in its financial reporting procedures during FY 2006, the agency's third year of preparing audited financial statements. Among other initiatives, the Office of Financial Management: (i) completed documentation of a comprehensive set of policies and procedures for financial reporting; (ii) improved documentation of the audit trail between general ledger accounts and the financial statements; (iii) prepared interim financial statement notes for review by senior management; and (iv) added key staff with expertise in governmental financial reporting. In addition, the SEC formalized the membership, procedures, and responsibilities of the Financial Management Oversight Committee, which has oversight responsibility with respect to all aspects of the SEC's financial management, including financial reporting and internal controls. The Committee is comprised of the Director of Corporation Finance, the Director of Enforcement, the General Counsel, the Chief Accountant, the Executive Director, and the Chief Financial Officer, and chaired by the Chairman.

In FY 2007, the SEC will seek to build on these improvements by, among other things: (i) further educating staff throughout the SEC on the agency's internal controls over financial reporting; (ii) strengthening controls over the recording of property and equipment and payroll expenses; (iii) utilizing new information systems to facilitate the preparation of financial statements; and (iv) introducing new procedures for management's assessment of internal controls, to ensure compliance with the requirements of OMB Circular A-123 on *Management's Responsibility for Internal Control.*

Recording and reporting of disgorgement and penalties. During FY 2006, the SEC took a number of important steps to ensure the integrity of enforcement-related disgorgement and penalty data. To address inaccuracies in the existing database, the Division of Enforcement completed a comprehensive Delinquent Debt Project, which involved verifying the recorded data with respect to all outstanding enforcement debts and taking appropriate steps regarding the collection of those debts. The Division also conducted an internal audit of year-end enforcement receivables. To ensure the quality of new data going forward, the SEC introduced new controls over the recording of enforcement receivables. These controls involve the participation of the Office of the Secretary and the Office of Financial Management, in addition to the Division of Enforcement, and they are designed to make certain that the disgorgement and penalty data recorded and reported on the SEC's financial statements are accurate, timely, and complete. The agency also completed the design of a new financial management information system for tracking disgorgement and penalties that will replace the financial portion of Enforcement's existing case tracking database.

In FY 2007, the SEC will continue to strengthen the financial management of all aspects of the enforcement program. The SEC's planned actions are designed to address the reportable conditions in this area identified during GAO's FY 2006 financial audit. The Office of Information Technology (OIT) expects to roll out the new financial management system for disgorgement and penalties by the second quarter, and OIT will be working on additional systems improvements to enhance the tracking and management of money ordered in enforcement cases. The Division of Enforcement will continue its efforts to educate all enforcement attorneys about the additional steps necessary to maintain strong internal controls at the SEC and to ensure transparency and uniformity in the agency's approach to monetary sanctions. Another priority for the SEC, as discussed in the following section, is to achieve greater efficiencies in the management and distribution to harmed investors of fair funds and other distribution funds.

Information security. During the past year, the SEC implemented a wide variety of new policies and procedures governing the assessment and management of information security risk. These procedures include comprehensive approaches for identifying security risk; configuring, testing, and monitoring information systems; incident response; remedial action tracking; and many other areas. The SEC also completed the certification and accreditation of its major systems, and conducted awareness training for 99 percent of SEC staff. In addition, the agency also established and tested its disaster recovery and business continuity plans in accordance with recommendations from previous years.

The SEC will refine and extend the procedures and management controls put in place during FY 2006 to reduce the residual risk. The most important of these will be improvements in the processes for controlling changes to the technical environment, strengthening the management of user accounts and passwords, and measures to tighten the physical perimeter around sensitive areas of the SEC's premises. In addition, the agency will remediate a number of specific technical issues in such areas as patch management, data security, and intrusion detection systems. The SEC's planned actions with respect to information security are designed to address the reportable conditions in this area identified during GAO's FY 2006 financial audit.

Recording and reporting of property and equipment. The SEC's asset balances for property and equipment have increased substantially as a result of the growth and relocation of the agency's staff in recent years. The GAO audit found inaccuracies in recording of acquisition costs and dates and capitalization of internal use software. To address these issues, the agency's property management policies will be updated in FY 2007 to reflect the current organizational structure and revised business processes. To enhance data integrity and maximize the integration of the agency's financial systems, the SEC has begun to prepare requirements to replace the agency's current outdated asset management system. While replacement of the management information system will likely be a multiyear effort, the program will be strengthened in FY 2007 to ensure data integrity and timeliness by updating the policies, training staff on the new policies, and increasing quality checks throughout the year.

Efficiently Distributing Funds to Investors

Another high priority challenge for the SEC is improving the administration and distribution of fair funds and other distribution funds for the benefit of victims of securities law violations. The fair funds provision of the Sarbanes-Oxley Act of 2002 authorizes the SEC, in certain circumstances, to take penalties collected in enforcement cases and add them to disgorgement funds, making it possible to provide greater recovery to harmed investors. Fair funds and other distribution funds are collected by the SEC; and prior to distribution to harmed investors, these monies are generally held by the SEC in administrative cases and held by courts in civil cases.

Since 2002, the SEC has collected approximately $8 billion for distribution to harmed investors. The agency is continuing to meet the challenges of developing and administering distribution plans for this money, in what are often complex cases involving hundreds of thousands of injured investors. These challenges include: determining what classes of investors, during what time period, were harmed, and the relative harm to each particular class of investor; evaluating the potential tax consequences and other costs of a particular distribution; and managing the mechanics of a distribution, which involves locating and sending checks to what are often large numbers of investors. In recent years, the SEC has come up a steep learning curve with respect to these issues, and is now using that learning to speed the distribution of these funds.

During FY 2006, approximately $700 million of these funds were distributed to investors, including significant distributions related to the Global Research Analysts, NYSE specialists, and Bristol-Myers Squib enforcement matters. Also, the SEC staff regularly held conference calls with all of the Independent Distribution Consultants appointed to assist in distribution of the 26 fair funds established in the recent market timing and late trading mutual fund scandals, as well as engaged in one-on-one consultations with the IDCs. These calls assisted in working through the many issues arising in those cases and have added consistency to the agency's approach in these distributions. Additionally, the staff worked closely with representatives of the IRS and the Department of Labor on issues within their respective expertise related to these complex distributions.

In FY 2007, the SEC expects to distribute a significant amount of the approximately $3.3 billion dollars collected for distribution in those 26 mutual fund cases. In addition, the agency expects the distributions of $750 million from the WorldCom fair fund and $300 million from the Time-Warner AOL fair fund to commence in the first half of FY 2007.

The SEC has also taken several steps to increase the amounts returned to harmed investors. In particular, in administrative orders, the SEC now generally requires settling respondents to pay the costs of distributions. The SEC also seeks to consolidate funds from related cases, where appropriate. This step can save investors hundreds of thousands of dollars in separate, duplicative distribution actions. Similarly, where appropriate, the SEC seeks to save costs by distributing funds together with related private class actions. In such cases, the agency always ensures that no SEC recoveries are used to pay private class action lawyer fees. Finally, the SEC seeks to ensure that fair fund monies held by the SEC pending distribution are earning interest. To this end, the SEC has established an agreement with the Bureau of the Public Debt, pursuant to which nearly all disgorgement and penalty funds collected in administrative proceedings are invested in short-term Treasury securities, pending their distribution to injured investors.

Going forward, the SEC will continue to look for ways to streamline the distribution process so that monies are returned to harmed investors efficiently and in a timely manner.

Leveraging Information Technology

The SEC continues to make significant investments in information technology to support its business processes and improve the agency's performance of its mission; however, a number of important challenges remain to be addressed in the coming years.

Investor disclosure. While the SEC disseminates over 700,000 documents annually to the public, most of those filings are in text-based formats that can be difficult to efficiently search and analyze. The SEC has embarked on a major "interactive data" initiative to make the information much more easy to use, leveraging modern software technologies and data interchange formats such as eXtensible Business Reporting Language (XBRL).

Enforcement and examination management. The enforcement and examination programs comprise over 1,900 staff, and are critical to the SEC's investor protection mission. The management information systems used to oversee these programs, however, are antiquated and do not provide the kind of high-quality information capture and reporting that is required for such large programs. The SEC began a multiyear initiative to upgrade or replace these systems in 2006 beginning with a new system for tracking disgorgements and penalties, and plans to upgrade or replace the other key systems over the next two years.

Back office and financial systems. The SEC has historically not invested sufficiently in its administrative systems infrastructure, which has been a contributing factor to the internal controls issues discussed elsewhere in this report. The agency began to address these issues in 2006 with an upgrade to the core accounting system and other investments in procurement and budgeting systems; over the next three years, additional upgrades are planned.

Enhancing Risk Assessment

The SEC seeks to target its resources toward the fraudulent, illegal, or questionable practices that pose the greatest risks to investors and the markets. During FY 2006, under the leadership of the Office of Risk Assessment, the SEC worked to fully integrate risk assessment practices into its operations, particularly in the enforcement, examination, and disclosure review programs. For example, the SEC's examination program has employed techniques such as risk profiling and deploying monitoring teams at large advisory firms to better assist in risk assessment and detection and prioritize inspections. In addition, the agency piloted an IT system that will help SEC staff identify, prioritize, and manage the risks within each program area. As noted in the *Inspector General's Summary of Management Challenges,* in Section 3, the SEC plans to enhance further its risk assessment capabilities, by thinking strategically, identifying and prioritizing emerging issues, and coordinating agency resources and activities accordingly.

Human Capital Management

The SEC was proud to be named one of the top five places to work in the federal government, according to a survey conducted by *U.S. News & World Report* and the Partnership for Public Service. This honor is a testament to the agency's efforts over the last several years to improve its human capital management practices. However, more work remains to be done in this area, as the SEC continues to work in a challenging human capital environment and has been experiencing a rising attrition rate.

The Office of Human Resources (OHR) has adopted a set of strategic initiatives and a plan to organize its staff in alignment with the Human Capital Assessment and Accountability Framework developed by the Office of Management and Budget, the Office of Personnel Management, and the Government Accountability Office. OHR developed a strategy map and balanced scorecard to support effective execution of its strategy. However, the SEC still must work to complete implementation of its balanced scorecard in 2007, so it can be used to gauge the SEC's progress on its human capital goals and refine the agency's strategies and initiatives as appropriate.

Using this underlying framework, the SEC then must work to improve some important facets of its human capital planning. In the coming months, the agency will develop the framework for a comprehensive knowledge management program, establish a leadership curriculum to address succession planning needs, and use competency gap data to improve its training needs assessment system. In addition, the SEC will focus its attention on integrating all of its human capital systems, including those for performance management, selection, leadership and knowledge management, and succession planning. This integration should improve the coordination and information flow among the systems, which will improve the agency's human capital decision making.

MANAGEMENT CONTROLS AND COMPLIANCE WITH LAWS AND REGULATIONS

SEC management is responsible for the fair presentation of the principal financial statements in conformity with U.S. generally accepted accounting principles and the requirements of OMB Circular A-136, *Financial Reporting Requirements.* Management is also responsible for the fair presentation of the SEC's performance measures in accordance with OMB requirements. The quality of the SEC's internal control rests with management, as does the responsibility for identifying and complying with pertinent laws and regulations.

Chairman's Assurance Statement

Management controls in effect during FY 2006 provided reasonable assurance that, taken as a whole, the SEC's system of internal controls is achieving its objectives under Sections 2 and 4 of the Federal Managers' Financial Integrity Act.

Christopher Cox
Chairman

Federal Managers' Financial Integrity Act

The Federal Managers' Financial Integrity Act of 1982 (FMFIA) requires agencies to establish management controls over their programs and financial systems. Specifically, Section 2 of the Act requires an annual assessment of internal controls necessary to ensure compliance with applicable laws; protect against loss from waste, fraud, and abuse; and ensure receivables and expenditures are properly recorded. Section 4 requires an assessment of conformance with government-wide financial system requirements.

In accordance with guidance issued by the SEC's Office of the Executive Director, 28 office heads conducted reviews of their financial, administrative, and program management controls. The offices range in size from 6 to 602 positions, with an average of 131 positions at the end of FY 2006. This segmentation ensures comprehensive coverage of all SEC offices.

Each office head prepared an annual assurance statement that identified any control deficiencies that merit the attention of the Chairman.

These statements were based on information gathered from various sources, including, among other things:

- Management's personal knowledge gained from the daily operation of the office;
- Management reviews and dashboard reports (which are monthly reports used to track the progress on operational, budgetary, and staffing objectives, and to adjust processes and resources as necessary);
- Government Accountability Office and Office of Inspector General reports;
- Self-assessments;
- Annual performance plans and reports;
- Audits of the agency's financial statements;
- Reports and other information from Congress, the Office of Management and Budget, the Office of Personnel Management, or similar agencies; and
- Other reviews relating to the office's operations.

Upon evaluation of the Section 2 and 4 submissions, recommendations from the Office of the Inspector General, and other supplemental sources of information, the agency's Financial Management Oversight Committee advised the Chairman whether the SEC had any management control deficiencies serious enough to be reported as a material weakness or nonconformance.

To be considered a material weakness in management control for FMFIA reporting purposes, the deficiency should be significant enough that it meets one or more of the FMFIA material weakness criteria.

The accompanying chart describes the criteria that the SEC uses for the FMFIA review.

Material Weakness Criteria

- Significantly impairs the fulfillment of the SEC's mission.
- Deprives the public of needed services.
- Violates statutory or regulatory requirements.
- Significantly weakens established safeguards against waste, loss, unauthorized use or misappropriation of funds, property, other assets.
- Results in financial or program information that is significantly in error, or incomplete.
- Results in conflict of interest.
- Merits the attention of the Chairman, the President, or a relevant Congressional oversight committee.
- Of a nature that omission from the report could reflect adversely on the SEC's management integrity.

Management concluded that controls in effect during FY 2006 provided reasonable assurance that the SEC's system of internal controls is achieving its objectives under Sections 2 and 4 of the FMFIA, and that the SEC has no material weaknesses in internal controls. As described below, the SEC fully resolved the four material weaknesses reported as a result of last year's FMFIA review process.

Other Reviews

Also during the year, the Office of Inspector General and the Office of Information Technology conducted a combined total of 22 alternative reviews. More than half of all Commission offices were reviewed. Several offices underwent multiple reviews.

Further, the Office of Information Technology certified and accredited eight major applications; recertified the agency's accounting and general support systems because of major upgrades; and completed 14 electronic authentication risk assessments. E-authentication is a review process at the transaction level designed to help agencies ensure that authentication processes provide the appropriate level of assurance.

Finally, GAO audited the Commission's financial statements. GAO's procedures included audits of the FY 2006 financial statements, internal controls over the financial systems and operating procedures affecting the statements, the SEC's compliance with selected provisions of law and regulations applicable to the management of financial resources, and actions taken in response to prior GAO audit recommendations.

Status of Internal Controls over Financial Reporting

In FY 2006 the SEC focused substantial effort on resolving three material weaknesses in internal controls over financial reporting. Those efforts were successful and, as confirmed in the auditor's report, the SEC now has no material weaknesses in internal controls. Plans for FY 2007 will address reportable conditions identified by GAO in the FY 2006 financial audit.

The following is a summary of the status of the SEC's efforts in these areas, which are also discussed in the *Challenges* section.

Financial statement preparation process

Description. In FY 2005, the SEC had a material weakness related to its preparation of financial statements, due, among other things, to incomplete documentation of policies and procedures, weaknesses in the audit trail between general ledger accounts and the financial statements, and insufficient staff.

Corrective actions taken. The SEC made substantial improvements in its financial reporting procedures during FY 2006, resolving the material weakness. Among other initiatives, the Office of Financial Management: completed documentation of key policies and procedures for financial reporting; improved documentation of the audit trail between general ledger accounts and the financial statements; prepared interim financial statement notes; and added key staff. In addition, the SEC formalized the membership, procedures, and responsibilities of the Financial Management Oversight Committee.

Further actions planned. In FY 2007, the SEC will seek to build on these improvements by, among other things: further educating staff about internal controls; strengthening controls over the recording of property and equipment and payroll expenses; utilizing new information systems to facilitate the preparation of financial statements; and introducing new procedures for management's assessment of internal controls, to ensure compliance with the requirements of OMB Circular A-123 on *Management's Responsibility for Internal Control.*

Reporting and recording of disgorgement and penalties

Description. In FY 2005, the SEC had a material weakness related to its recording and reporting of disgorgement and penalties ordered as a result of SEC enforcement actions. Limitations in the database used to track and record disgorgement and penalty activity, inadequate coordination between different SEC offices, and incomplete policies and procedures had resulted in financial data inaccuracies.

Corrective actions taken. During FY 2006, the SEC took a number of important steps to ensure the integrity of enforcement-related disgorgement and penalty data: the Division of Enforcement completed a comprehensive Delinquent Debt Project; the agency introduced new controls over the recording of enforcement receivables; and the agency completed the design of a new financial management information system for tracking disgorgement and penalties that will replace the financial portion of Enforcement's existing case tracking database.

Further actions planned. In FY 2007, the SEC will continue to strengthen the financial management of all aspects of the enforcement program: OIT expects to roll out the new financial management system for disgorgement and penalties by the second quarter; Enforcement will continue its efforts to educate all enforcement attorneys about the additional steps necessary to maintain strong internal controls; and the agency will continue to seek greater efficiencies in the management and distribution to investors of fair funds and other distribution funds.

Information security

Description. Effective information system controls are required to provide assurance that financial information is adequately protected from misuse, fraud, improper disclosure, or destruction. These controls take the form of technical safeguards, such as firewalls and application design, as well as procedural controls, such as access management and segregation of duties. The SEC has previously reported a material weakness related to its information systems and security controls. These issues stemmed from the historical lack of a comprehensive agency program to manage information security, as well as a number of specific technical weaknesses.

The GAO audit for FY 2006 revealed notable progress on all fronts. In particular, the auditors noted significant improvements in the overall management of the information security program, and found that 51 of the 65 open findings from the previous two years' audit cycles had been resolved. In addition, they noted strong improvements in logical access controls (e.g., password management, database controls) and business continuity planning. The auditors also identified areas where further progress is needed; these include ensuring proper controls over changes to systems, securing physical access to systems and sensitive areas, and appropriately segregating duties and roles within information systems. As a result of the progress made over the last year, GAO determined that while these security gaps still constitute a reportable condition that risk no longer constitutes a material weakness in internal controls.

Corrective actions taken. During the past year, the SEC implemented a wide variety of new policies and procedures governing the assessment and management of information security risk. These procedures include comprehensive approaches for identifying security risk; configuring, testing, and monitoring information systems; incident response; remedial action tracking; and many other areas. The SEC also completed the certification and accreditation of its major systems, and conducted awareness training for 99 percent of SEC staff. The SEC also established and tested its disaster recovery and business continuity plans in accordance with recommendations from previous years.

Further actions planned. The SEC will refine and extend the procedures and management controls put in place during FY 2006 to reduce the residual risk. The most important of these will be improvements in the processes for controlling changes to the technical environment, strengthening the management of user accounts and passwords, and measures to tighten the physical perimeter around sensitive areas of the SEC's premises. In addition, the agency will remediate a number of specific technical issues in such areas as patch management, data security, and intrusion detection systems.

Status of Controls over Budget Planning

Description. In May 2005, the SEC disclosed that it underfunded the construction and build-out of the agency's new facilities in Washington, New York, and Boston by about $48 million. Although the SEC remedied the error by paying all of these expenses upfront, saving taxpayers millions in financing costs, this event also revealed an underlying weakness in the agency's budget planning and facilities management processes, which was described in last year's Performance and Accountability Report. A GAO study found that the SEC should, among other things, establish accountability at both the staff and management levels for the reasonableness of budget estimates, establish regular managerial review procedures related to these and future facilities projects, and add new budgeting and facilities management positions to the Office of Administrative Services and Office of Financial Management. In FY 2006, the SEC finished implementing the GAO recommendations and has now fully resolved this weakness.

Corrective actions taken. In July 2006, the SEC implemented the initial phase of the BPPAS system, an activity-based costing and performance-based budgeting system, which will significantly enhance the SEC's capabilities to report and analyze its financial planning, budgeting, cost-assignment, and operations performance. BPPAS has further strengthened the budget process by providing more auditable and transparent budget formulation and execution processes. In addition, extensive consultations took place among SEC management, facilities and budgeting staff, the Office of Information Technology, and the agency's program offices to ensure that all offices' needs were addressed in both the construction and the budget for these projects. As a result of such efforts, the agency successfully completed all three facilities in spring 2006, and achieved $5 million in combined savings on these projects. The SEC also added staff resources to operate the new BPPAS system, conduct detailed analyses of funding requests, and enhance the agency's facilities management function. With these and other steps completed, the SEC has fully addressed GAO's recommendations.

Further actions planned. The SEC will continue to strengthen its budgeting and facilities management programs. The agency will further integrate the new BPPAS system into its operations, offering agency managers more detailed analyses than ever before about the costs of their programs. Also, the SEC will continue enhancing its long-range planning for the agency's facilities and other administrative costs.

Financial Management Systems

Although the SEC is not required to report under the Federal Financial Management Improvement Act, the agency assesses its financial systems annually, and engages in continuous efforts to strengthen and integrate financial management systems. An analysis of options for upgrading the accounting system will be initiated in early FY 2007.

Federal Information Security Management Act

FISMA requires federal agencies to conduct an annual self-assessment of their IT security programs, to develop and implement remediation efforts for identified security weaknesses and vulnerabilities, and to report compliance to OMB. The SEC's Inspector General and Chief Information Officer performed a joint review of the agency's compliance with FISMA requirements, and submitted the report to OMB in late September. The report showed that the SEC had successfully eliminated six of the seven significant deficiencies identified during the 2005 FISMA review, with the seventh downgraded to a reportable condition. The report also identified five new reportable conditions, where the agency has opportunities to further improve its controls by strengthening risk assessment processes, improving the rigor of the certification and accreditation process, and conducting privacy impact assessments on key systems.

Prompt Payment Act

The Prompt Payment Act requires federal agencies to report on their efforts to make timely payments to vendors, including interest penalties for late payments. In FY 2006 the SEC did not incur interest penalties on 95 percent of the 14,228 vendor invoices processed, representing payments of approximately $247 million. Of the invoices that were not processed in a timely manner, the SEC was required to pay interest penalties on 769 invoices, but was not required to pay interest penalties on 776 invoices where the interest was calculated at less than $1. In FY 2006, the SEC paid approximately $69,000 in interest penalties, or $278 in interest penalties for every million dollars of vendor payments.

Improper Payments Information Act

The Improper Payments Information Act requires federal agencies to review annually all programs and activities they administer, identify those which may be susceptible to significant erroneous payments and the extent of the erroneous payments in its programs, and report the actions it is taking to reduce erroneous payments. During FY 2006, the SEC had controls in place to identify and correct erroneous payments which, in total, did not exceed the $10 million threshold.

Debt Collection Improvement Act

The Debt Collection Improvement Act prescribes standards for the administration, collection, compromise, suspension, and termination of federal agency collection actions and referral to the proper agency for litigation. In FY 2006, the SEC referred approximately $148 million to the Department of the Treasury for collection. Collections of delinquent debt by Treasury for the same period were approximately $244,000.

PERFORMANCE MEASURES SUMMARY

FY 2006 marks the third year that the SEC has reported program performance in its annual Performance and Accountability Report.

The SEC's performance measures were developed by a Government Performance and Results Act team consisting of dedicated staff from throughout the agency. The team strived to craft meaningful performance measures that best reflect the SEC's progress in achieving the goals laid out in its five-year strategic plan.

In general, these measures gauge how much activity the SEC conducts in a given fiscal year, how quickly it accomplishes its tasks, and what effects these activities have on the markets and investors. Of these three components, measuring effectiveness is the most challenging for the SEC, as is the case for many regulatory and law enforcement agencies. In many instances, the agency's impact can only be indirectly assessed. The agency will continue to explore ways to improve these measures, and this effort will be aided by the SEC's new activity-based costing and performance-based budgeting system, which was implemented in FY 2006.

This fiscal year, the Commission worked diligently to meet or exceed performance targets. Of the 21 performance goals the Commission is reporting on in FY 2006, the SEC met or exceeded 15 goals.

A summary of the SEC's major performance measures, organized by goal, is presented in *Exhibit 1.7.*

EXHIBIT 1.7

Performance Results Summary

GOAL 1 ENFORCE COMPLIANCE WITH THE FEDERAL SECURITIES LAWS	FY06 PERFORMANCE
1. Number of Requests To and By Foreign Regulators for Enforcement Assistance	+
2. Percentage of first enforcement cases filed within two years	–
3. Enforcement cases successfully resolved	+
4. Investment advisers and investment companies examined	–
5. Distribution of cases across core enforcement areas	+

GOAL 2 PROMOTE HEALTHY CAPITAL MARKETS THROUGH AN EFFECTIVE AND FLEXIBLE REGULATORY ENVIRONMENT	FY06 PERFORMANCE
1. Global Access to U.S. markets:	
a. Number of new foreign private issuers registering	+
b. Dollar amount of securities registered by foreign private issuers	–
2. Milestones achieved for international regulatory cooperation	✓
3. Percentage of responses to exemptive, no-action letter, and interpretive requests issued within six months	✓
4. Percentage of SRO rule filings closed in less than 60 days	+

GOAL 3 FOSTER INFORMED INVESTMENT DECISION MAKING	FY06 PERFORMANCE
1. Percentage of reporting corporations and investment companies with disclosures reviewed by the SEC:	
a. Corporations	+
b. Investment companies	+
2. Percentage of investment adviser and investment company transactional reviews completed within timeliness goals	+
3. Average time to issue initial comments on Securities Act filings	+
4. Annual number of online searches for EDGAR filings	+
5. Percentage of forms and submissions filed electronically and in a structured format	✓
6. Number and percentage of investor complaints, questions, and requests completed by the Office of Investor Education and Assistance (OIEA) within seven calendar days	–
7. OIEA publications distributed by the GSA	–

GOAL 4 MAXIMIZE THE USE OF SEC RESOURCES	FY06 PERFORMANCE
1. Staff turnover rate	–
2. Milestones achieved on major human capital initiatives	✓
3. Receive an unqualified audit opinion on the agency's audited financial statements with no material weaknesses noted on the agency's internal controls	
a. Audit opinion	+
b. Material weaknesses	+
4. Percentage of IT projects that adhere to the agency's capital planning investment control process	+
5. Milestones for major IT projects	✓

Key: Level of Performance Attained

\+ Exceeded Target or Prior Year Level
✓ Achieved Target or Maintained Prior Year Level
– Less than Target or Prior Year Level

The SEC's financial statements present the financial position, net cost of operations, changes in net position, budgetary resources, financing, and custodial and fiduciary activities of the SEC's core business activities as of and for the fiscal years ended September 30, 2006 and 2005.

Overview

The SEC's financial statements were prepared in conformity with U.S. generally accepted accounting principles and OMB Circular A-136, *Financial Reporting Requirements.* The financial statements, footnotes, and auditor's opinion appear in Section 3 of this Performance and Accountability Report. A summary of the SEC's major financial activities in FY 2006 and 2005 is presented below.

Assets

The SEC's assets are classified as either "entity assets" or "non-entity" assets. Entity assets belong to the agency, and can be used to fund SEC's operations to the extent authorized by Congress. The SEC earns revenues through the collections of transaction fees from securities exchanges and registration fees from issuers. These amounts can be used by the agency only to the extent of spending limits enacted by Congress. Amounts collected in excess of such spending limits are considered restricted entity assets, and can be used only when subsequently authorized by Congress.

Non-entity assets are assets that are held by the SEC on behalf of another federal agency or other third party. The SEC's non-entity assets primarily relate to disgorgement and penalties ordered in enforcement proceedings against securities law violators. The SEC records receivables when such amounts are payable directly to the SEC, but not when they are payable to a court, receiver, or other third party. Once collected, these amounts are either sent to the General Fund of the Treasury or held for distribution to harmed investors. Amounts held pending distribution to investors are generally invested in short-term Treasury securities.

EXHIBIT 1.8

Assets at September 30, 2006 and 2005

(DOLLARS IN THOUSANDS)	ENTITY ASSETS	ENTITY ASSETS RESTRICTED	NON-ENTITY ASSETS	TOTAL
September 30, 2006				
Fund Balance With Treasury	$353,913	$4,752,856	$ 72,124	$ 5,178,893
Cash	—	—	—	—
Investments	—	—	3,674,528	3,674,528
Accounts Receivable—Federal Agencies	131	—	154,375	154,506
Accounts Receivable—Public	105,946	—	71,545	177,491
Advances and Prepayments	974	—	—	974
Property and Equipment, Net	103,631	—	—	103,631
Total Assets—FY 2006	$564,595	$4,752,856	$3,972,572	$9,290,023
September 30, 2005				
Fund Balance With Treasury	$ 371,798	$3,703,675	$ 273,463	$4,348,936
Cash	9	—	—	9
Investments	—	—	1,768,024	1,768,024
Accounts Receivable—Federal Agencies	194	—	—	194
Accounts Receivable—Public	126,889	—	95,512	222,401
Advances and Prepayments	657	—	—	657
Property and Equipment, Net	73,309	—	—	73,309
Total Assets—FY 2005	$572,856	$3,703,675	$2,136,999	$ 6,413,530

Fund Balance With Treasury

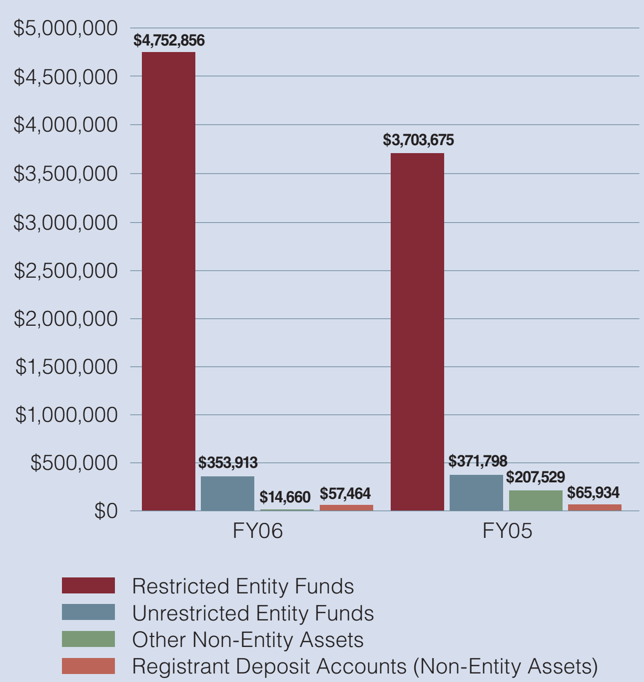
Fund Balance With Treasury includes the following assets: (1) restricted balances that cannot be used without further authorization by Congress; (2) unrestricted balances available to finance expenditures; (3) uninvested fiduciary assets, consisting of disgorgement, penalties, and interest held by the SEC pending distribution to harmed investors or remittance to the General Fund of the Treasury; and (4) registrant deposits, representing excess filing fees paid by registrants.

At September 30, 2006 and 2005, Fund Balance With Treasury was $5,178.9 million (representing 55.7 percent of total assets) and $4,348.9 million (representing 67.8 percent of total assets), respectively. The increase at fiscal year-end 2006 was due mainly to an increase in restricted entity assets, representing transaction and registration fee revenues, offset in part by a reduction in uninvested fiduciary assets.

EXHIBIT 1.9

Fund Balance With Treasury at Year-End

(DOLLARS IN THOUSANDS)



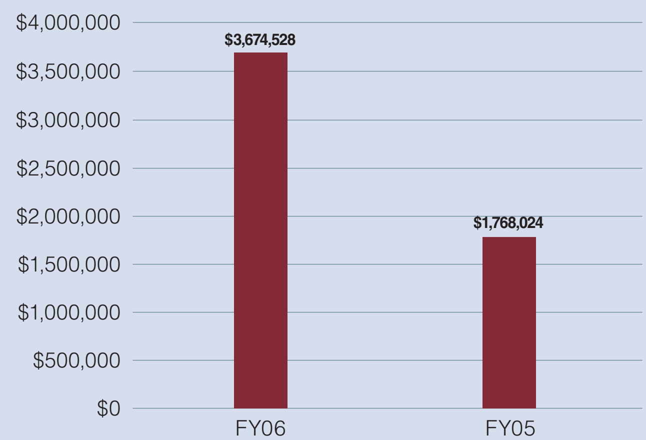
As presented in *Exhibit 1.9,* restricted funds are the bulk of the SEC's Fund Balance With Treasury. These funds represent primarily the cumulative amount of transaction and registration fees paid to the SEC since 1991 in excess of what the agency has been authorized by Congress to use to fund its annual operations.

Investments

EXHIBIT 1.10

Fiduciary Investments

(DOLLARS IN THOUSANDS)



The SEC's Investments balance totaled $3,674.5 million and $1,768.0 million at September 30, 2006 and 2005, respectively. These investments consisted entirely of disgorgement and penalties collected from securities law violators (and interest earned thereon), which are held by the SEC pending future distribution to harmed investors. The SEC invests these funds in overnight and short-term market-based Treasury bills issued through the Treasury Department's Bureau of Public Debt. The increase in the investment balance at fiscal year-end 2006 represents an increase in funds collected from securities law violators, as well as the transfer to SEC custody of certain amounts that were previously being held with third party escrow agents.

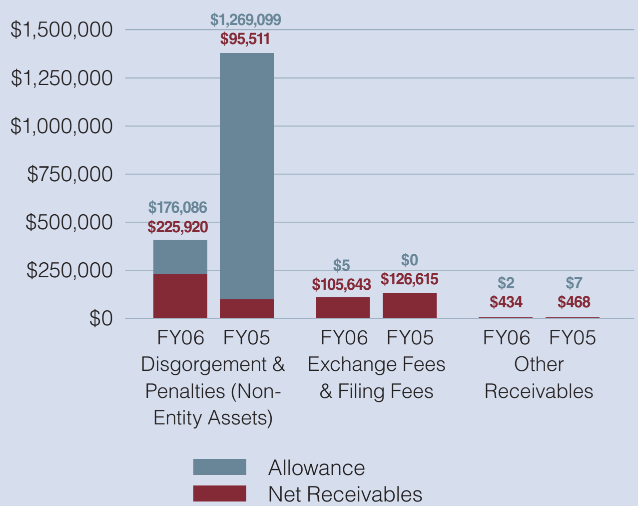
The SEC expects to distribute to investors during FY 2007 a substantial portion of the amounts held for investment at fiscal year-end 2006.

Accounts Receivable

EXHIBIT 1.11

Accounts Receivable

(DOLLARS IN THOUSANDS)



At September 30, 2006 and 2005, the SEC's net accounts receivable totaled $332.0 million and $222.6 million, respectively. These amounts consisted of gross accounts receivable of $508.1 million and $1,491.7 million, respectively, offset by an estimated allowance for doubtful accounts of $176.1 million and $1,269.1 million, respectively.

The largest portion of the SEC's gross accounts receivable relates to disgorgement and penalties assessed against securities law violators in enforcement proceedings. As noted above, the SEC records receivables when such amounts are payable directly to the SEC, but not when they are payable to a court, receiver, or other third party. The SEC also records receivables in the event that amounts collected by a court or third party are transferred to the SEC, pursuant to a Commission or court order. At September 30, 2006, accounts receivables included approximately $154.4 million due from a district court, which will be combined with existing fair funds in the SEC's custody for distribution to harmed investors.

The SEC's allowance for doubtful accounts is the agency's estimate of how much of the gross accounts receivable are uncollectible. The overall allowance is based on an analysis of certain large individual accounts receivable and historical collection activity that is applied to the balance of the accounts receivable.

Effective June 30, 2006, the SEC implemented a new method for writing off debts that are two or more years old. The new write-off method calls for the SEC to write off debts that are two or more years old by removing the amount of the debts from the gross accounts receivable and any related allowance for doubtful accounts. This write-off policy is consistent with prior SEC policy on the calculation of the allowance for doubtful accounts, which called for a 100 percent reserve of any debt that was two or more years old. By implementing the new method, the SEC removed $1,081 million of debts as well as the corresponding allowance for doubtful accounts. The effect of this change in accounting method is seen in the September 30, 2006 balance of gross accounts receivable and the related allowance for disgorgements and penalties. The write-off policy does not affect the enforceability of the debts or agency's efforts to collect delinquent debts.

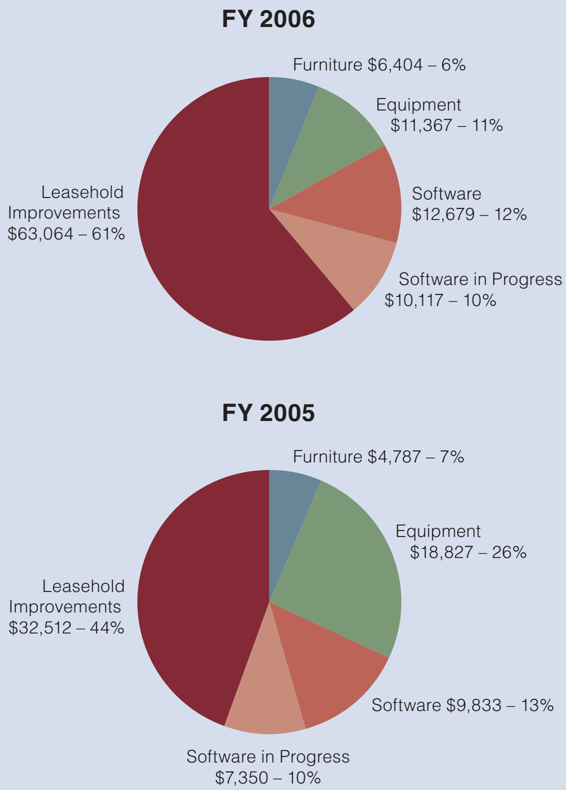
Property and Equipment

The SEC's property and equipment consists of software and general purpose equipment used by the agency; capital improvements made to buildings leased by the SEC for office space; and internal use software development costs for projects in development. The net cost of the SEC's property and equipment for the last two years is summarized in *Exhibit 1.12.*

EXHIBIT 1.12

Property and Equipment, Net of Accumulated Depreciation

(DOLLARS IN THOUSANDS)



The significant increase in leasehold improvements relates primarily to the fact that the SEC occupied new office space in Washington, D.C., New York, and Boston during FY 2006.

Liabilities

The SEC's liabilities consist of routine operating accounts payable, accrued payroll and benefits, registrant deposit accounts, and fiduciary and custodial liabilities associated with disgorgement and penalties assessed against securities law violators.

The SEC records a custodial liability for the net amount of enforcement-related receivables, after taking into account the estimated allowance for doubtful accounts. Upon collection, these amounts will either be transferred to the fiduciary accounts or transferred to the General Fund of the Treasury.

The SEC's largest liability is the fiduciary liability associated with amounts collected by the SEC in enforcement proceedings and held for future distribution to harmed investors. When collected, these receipts are held as fiduciary assets in Fund Balance With Treasury or Investments, pending distribution to investors, and this equal and offsetting liability is reported on the balance sheet. The increase in fiduciary liability from $1,975.6 million at September 30, 2005 to $3,834.7 million at September 30, 2006 reflects an increase in funds collected from securities law violators, as well as the transfer to SEC custody of certain amounts that were previously being held with third party escrow agents.

EXHIBIT 1.13

Liabilities at September 30, 2006 and 2005

(DOLLARS IN THOUSANDS)	LIABILITIES FUNDED BY BUDGETARY RESOURCES	LIABILITIES NOT FUNDED BY BUDGETARY RESOURCES	TOTAL
September 30, 2006			
Accounts Payable	$ 62,135	$ —	$ 62,135
Accrued Payroll, Benefits & Leave	20,836	38,779	59,615
Registrants' Deposit Accounts	57,464	—	57,464
Fiduciary Liability	3,834,662	—	3,834,662
Custodial Liability	71,545	—	71,545
Capital Lease Liability	—	27,641	27,641
Other Accrued Liabilities	14,839	—	14,839
Total Liabilities	$4,061,481	$66,420	$ 4,127,901
September 30, 2005			
Accounts Payable	$ 44,862	$ —	$ 44,862
Accrued Payroll, Benefits & Leave	21,138	38,544	59,682
Registrants' Deposit Accounts	65,934	—	65,934
Fiduciary Liability	1,975,553	—	1,975,553
Custodial Liability	95,512	—	95,512
Capital Lease Liability	—	21,647	21,647
Other Accrued Liabilities	7,023	—	7,023
Total Liabilities	$2,210,022	$60,191	$2,270,213

Federal liabilities are classified as either Funded by Budgetary Resources or Not Funded by Budgetary Resources. Nearly all of the SEC's liabilities are covered by budgetary resources, indicating that no further Congressional appropriation is necessary for the SEC to settle these liabilities. Annual leave balances at the end of a fiscal year are by definition unfunded since this leave will be paid out of current year funds at the time the leave is used by the employee.

Revenues and Costs

For FY 2006 and FY 2005, the SEC's net income from operations totaled $993.7 million and $827.5 million, respectively. These net amounts reflected exchange revenues of $1,882.6 million and $1,745.1 million, respectively, for FY 2006 and FY 2005, offset by costs of operations of $888.9 million and $917.7 million, respectively.

The SEC's exchange revenues are reported on the Statement of Net Cost. Exchange revenue is defined as revenues that are generated from arm's length transactions. The SEC earns revenues from fees paid pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934. Thus, the SEC's exchange revenues consist mainly of securities transaction fees paid by securities exchanges, and securities registration, tender offer, merger, and other fees paid by issuers. These fees are used to fund SEC programs and operations up to the limits established through appropriations.

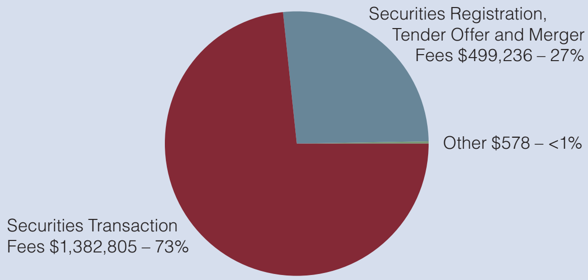
Non-exchange revenues are not reported on the Statement of Net Cost. Non-exchange revenues are defined as revenues that arise from the government's ability to demand payment. The SEC's non-exchange revenues consist of amounts collected in enforcement proceedings from violators of securities laws. These revenues are reflected in the Statement of Custodial Activity and are discussed separately below. *Exhibit 1.14* shows a breakdown of the SEC's exchange revenues for FY 2006 and FY 2005.

EXHIBIT 1.14

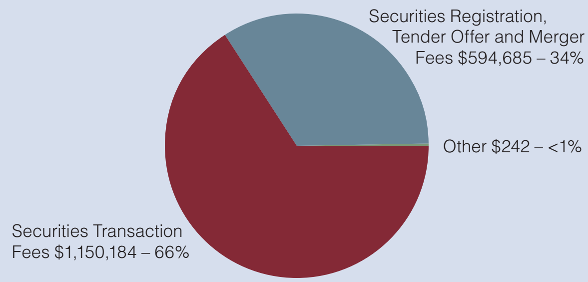
Exchange Revenue

(DOLLARS IN THOUSANDS)

FY 2006



FY 2005

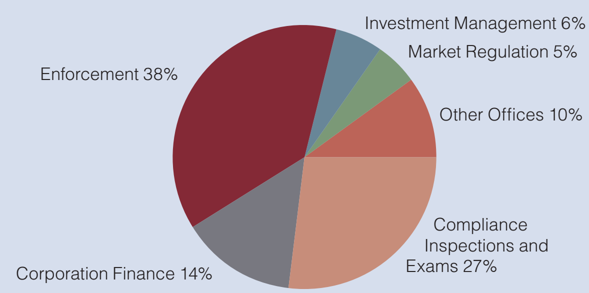


The SEC's costs of operations are reflected in the Statement of Net Cost and are allocated across the agency's six major program areas: Compliance Inspections and Examinations; Corporation Finance; Enforcement; Investment Management; Market Regulation; and Other Offices. The category Other Offices includes smaller program offices such as the Office of the General Counsel, the Office of the Chief Accountant, the Office of International Affairs, and the Office of Economic Analysis. Costs associated with the administration and management of the SEC have been allocated across program areas. *Exhibit 1.15* illustrates the breakdown of costs of operations for FY 2006 and FY 2005.

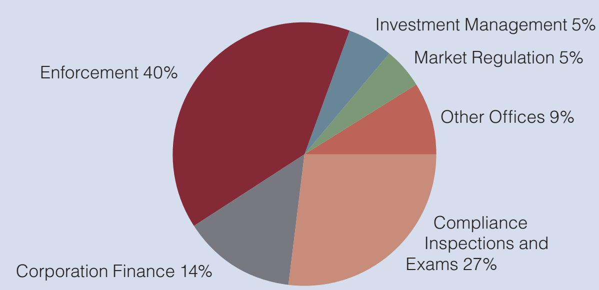
EXHIBIT 1.15

Costs

FY 2006



FY 2005



Budgetary Resources

As discussed above, the SEC receives its funding from fee revenue earned, which must be appropriated by Congress before it can be used by the SEC. The Statement of Budgetary Resources provides information on the budgetary resources that were made available to the SEC for the fiscal year and the status of those resources at the end of the fiscal year. For FY 2006 and FY 2005, the SEC had budgetary resources of $5,775.5 million and $4,801.9 million, respectively, which included amounts collected in current and prior years in excess of amounts the agency was authorized to spend. For FY 2006 and FY 2005, the SEC incurred obligations of $896.9 million and $960.8 million, respectively.

The SEC had unobligated balances of $3,840.6 million at the beginning of FY 2006 and $3,049.3 million at the beginning of FY 2005. These balances reflect amounts collected in prior years by the SEC in excess of amounts it has been authorized to spend. Current year collections were $1,903.6 million in FY 2006 and $1,665.6 million in FY 2005, and are reflected in Spending Authority from Offsetting Collections.

Custodial Activity

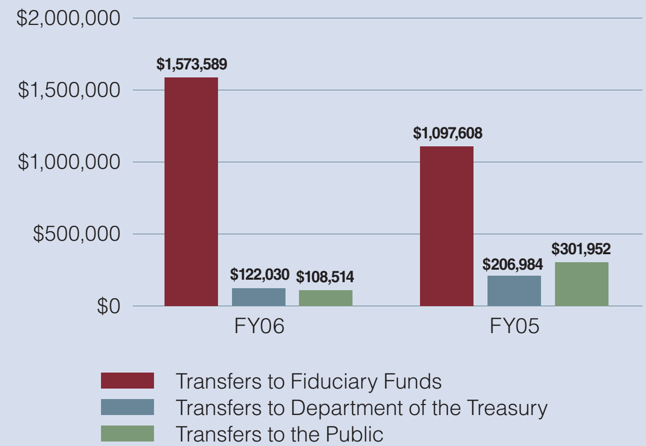
The Statement of Custodial Activity reflects collections by the SEC of disgorgement and penalty amounts from securities laws violators. These collections constitute non-exchange revenue, because they arise from the SEC's authority to demand payment from violators of the law. Custodial collections totaled $1,804.1 million and $1,606.5 million for FY 2006 and FY 2005, respectively.

The Statement of Custodial Activity also reflects the disposition of custodial collections. Once collected, disgorgement and penalty amounts are either transferred to the General Fund of the Treasury, held in the SEC's fiduciary fund pending distribution to harmed investors (or a determination whether such distribution is practicable), or distributed to harmed investors. *Exhibit 1.16* shows the breakdown of distribution of custodial collection for FY 2006 and FY 2005.

EXHIBIT 1.16

Distribution of Custodial Collections

(DOLLARS IN THOUSANDS)



FY 2006 distributions included $122.0 million transferred to the General Fund of the Treasury, $108.5 million distributed to harmed investors, and $1,573.6 million held in SEC fiduciary accounts at the Treasury pending distribution. FY 2005 distributions included $207.0 million transferred to the General Fund of the Treasury, $302.0 million distributed to investors, and $1,097.6 million held pending future distribution.

Limitations

The SEC has prepared its FY 2006 financial statements in accordance with the requirements of OMB Circular A-136, *Financial Reporting Requirements.* This document incorporates the concepts and standards contained in the Statements of Federal Financial Accounting Concepts and the Statements of Federal Financial Accounting Standards (SFFAS) recommended by the Federal Accounting Standards Advisory

Board (FASAB) and approved by the Secretary of the Treasury, the Director of the OMB, and the Comptroller General.

In 1999, the American Institute of Certified Public Accountants Council designated the FASAB as the accounting standards-setting body for federal government entities. Therefore, the SFFAS constitute generally accepted accounting principles for the federal government. These concepts and standards have been set by FASAB to help Federal agencies comply with the requirements of the Chief Financial Officers' Act of 1990, as amended by the Government Management Reform Act of 1994. Among other things, these two acts demand financial accountability from federal agencies and require the integration of accounting, financial management, and cost accounting systems.

The financial data in this report and the financial statements that follow have been prepared from the accounting records of the SEC, in conformity with accounting principles generally accepted in the United States for the federal government. The SEC's financial statements consist of the Balance Sheet, the Statement of Net Cost, the Statement of Changes in Net Position, the Statement of Budgetary Resources, the Statement of Financing, and the Statement of Custodial Activities. The financial statements were prepared pursuant to the requirements of 31 U.S.C. 3515 (b). The following limitations apply to the preparation of the financial statements:

- While the statements are prepared from books and records in accordance with the formats prescribed by OMB, the statements are in addition to the financial reports used to monitor and control budgetary resources, which are prepared from the same books and records.
- The statements should be read with the realization that the SEC is a component of the U.S. Government, a sovereign entity. One implication is that unfunded liabilities cannot be liquidated without legislation that provides resources to do so.

In addition, certain information contained in this financial discussion and analysis and in other parts of this Performance and Accountability Report may be deemed forward-looking statements regarding events and financial trends that may affect future operating results and financial position. Such statements may be identified by words such as "estimate," "project," "plan," "intend," "believe," "expect," "anticipate," or variations or negatives thereof or by similar or comparable words or phrases. Prospective statements are subject to risks and uncertainties that could cause actual results to differ materially from those expressed in the statements. Such risks and uncertainties include, but are not limited to, the following: changes in U.S. or global economic conditions; the availability, hiring and retention of qualified staff employees; government regulations; disputes with labor organizations; and deployment of new technologies. The SEC undertakes no obligation to publicly update these financial statements to reflect events or circumstances after the date hereof, or to reflect the occurrence of unanticipated events.

PERFORMANCE SECTION

The SEC is reporting the results of 21 performance measures that gauge the agency's progress in FY 2006 in fulfilling its mission and meeting its strategic goals. The measures presented in this report provide useful information regarding the Commission's efforts to detect violations and potential problems in the securities markets; establish regulations that strengthen corporate and fund governance; provide investors with timely and accurate disclosure materials; and ensure that the agency maintains effective internal operations. Together with ongoing managerial analyses and reviews, these measures help agency management determine where the SEC should allocate its budgetary resources. This section also includes a presentation of six indicators which provide further context for understanding the agency's activities.

Like other federal regulatory and law enforcement agencies, the SEC has found it challenging to develop measures that accurately depict the outcomes that the agency generates. In many instances, the Commission's impact can be assessed only indirectly. The SEC intends to continue refining its work in this area as it gains more experience in integrating its budget and performance functions.

DATA RELIABILITY AND COMPLETENESS

SEC managers use performance data to improve the quality of program management and to demonstrate accountability in achieving program results. The performance data presented in this report are complete and reliable, as outlined in guidance provided by OMB, and are as of September 30, 2006.

PERFORMANCE RESULTS BY STRATEGIC GOAL

The SEC's 2004–2009 strategic plan established four goals and 10 supporting outcomes that it seeks to achieve in carrying out its mission. The Commission uses a variety of performance measures to ascertain its progress in achieving these desired outcomes. The measures and results for FY 2006 are discussed below.

Goal 1: Enforce Compliance with Federal Securities Laws

Outcome 1.1 *Potential problems or issues in the securities markets are detected early, and violations of federal securities laws are prevented.*

See Section 1: Management's Discussion and Analysis, Exhibit 1.3: Investment Advisers and Investment Companies Examined.

EXHIBIT 2.1
PERFORMANCE MEASURE:

Number of Requests To and By Foreign Regulators for Enforcement Assistance

DESCRIPTION: Each year, the SEC makes hundreds of requests for enforcement assistance to foreign regulators, while responding to hundreds of other such requests from other nations. To facilitate this type of assistance, and encourage other countries to enact laws necessary to allow regulators to cooperate with their foreign counterparts, the SEC has entered into more than 30 bilateral information-sharing agreements, as well as the International Organization of Securities Commissions (IOSCO) Multilateral Memorandum of Understanding. These agreements create a framework for information sharing and expedite international cooperation among regulators.

	FY02	FY03	FY04	FY05	FY06 PLAN	FY06 ACTUAL
Requests to foreign regulators	448	309	380	438	460	561
Requests from foreign regulators	353	344	372	315	330	353

ANALYSIS OF RESULTS: The increased number of requests to foreign regulators reflects considerable growth in the number of investigations that have international components handled by Division of Enforcement staff. Part of the increase from last year reflects the efforts of the Office of International Affairs to assist the Division of Enforcement in its work related to the Delinquent Debt Project.

EXHIBIT 2.2
PERFORMANCE MEASURE:

Percentage of First Enforcement Cases Filed Within Two Years

DESCRIPTION: This measure identifies the percentage of first enforcement actions filed within two years of opening an investigation or inquiry. In conducting investigations, the Division of Enforcement continually strives to balance the need for complete, effective, and fair investigations with the need to file enforcement actions in as timely a manner as possible.

FY03	FY04	FY05	FY06 PLAN	FY06 ACTUAL
62%	69%	65%	66%	64%

ANALYSIS OF RESULTS: The figures on this chart depend on the types of cases brought or emphasized in a specific fiscal year as well as competing staff priorities, such as litigating actions already filed and bringing additional enforcement cases. In FY 2006, the SEC continued to file a large majority of its first enforcement actions within two years of opening an investigation or inquiry.

Outcome 1.2 *Violators of federal securities laws are detected and sanctioned.*

EXHIBIT 2.3
PERFORMANCE MEASURE:

Enforcement Cases Successfully Resolved

DESCRIPTION: A case is considered "successfully resolved" if it results in a favorable judgment for the SEC, a settlement, or the issuance of a default judgment. In general, the SEC strives to successfully resolve as many cases as possible, but at the same time, it aims to file large, difficult, or precedent-setting cases when appropriate, even if success is not assured.

FY04	FY05	FY06 PLAN	FY06 ACTUAL
98%	99%	85%	99%

ANALYSIS OF RESULTS: In FY 2006, the SEC met its goals in successfully resolving the cases against the vast majority of the defendants or respondents it charged.

See also Section 1: Management's Discussion and Analysis, Exhibit 1.2: Distribution of Cases Across Core Enforcement Areas.

Goal 2: Promote Healthy Capital Markets through an Effective and Flexible Regulatory Environment

Outcome 2.1 *Investors are protected by regulations that strengthen corporate and fund governance and adhere to high-quality financial reporting standards worldwide.*

Outcome 2.2 *Industry efforts to provide innovative and competitive products and trading platforms are supported while the markets remain vibrant, fair, accessible, and financially sound.*

EXHIBIT 2.4
PERFORMANCE MEASURE:

Global Access to U.S. Markets: Number of New Foreign Private Issuers Registering Securities with the SEC and the Dollar Amount of Securities Registered By Foreign Private Issuers

DESCRIPTION: The number of foreign companies registering securities in the United States and the amount of money they bring to the public markets can be viewed as an indicator of the integrity, liquidity, and fairness of the U.S. markets.

(DOLLARS IN BILLIONS)

	FY02	FY03	FY04	FY05	FY06 PLAN	FY06 ACTUAL
Companies	70	50	63	74	50	60
Dollar value	$147	$163	$146	$250	$250	$109

ANALYSIS OF RESULTS: The decrease in the number of new foreign companies registering their securities under the 1933 and 1934 Acts and the dollar value of securities registered under the 1933 Act may be the result of concerns some non-U.S. issuers have expressed about the impact and costs of compliance with the Sarbanes-Oxley Act should they register in the United States. In FY 2007, the Commission plans to develop and issue guidance for management to follow in assessing internal controls over financial reporting and to oversee the Public Company Accounting Oversight Board's (PCAOB) revision of its audit standard for internal control over financial reporting, as well as the PCAOB's implementation of those revisions. In order for companies and auditors to have the benefit of these efforts, the Commission also has announced delays in the implementation of the internal control requirements for certain smaller public companies.

EXHIBIT 2.5
PERFORMANCE MEASURE:

Milestones for International Regulatory Cooperation

DESCRIPTION: In order to sustain an effective and flexible regulatory environment in the face of increasingly global financial markets, the SEC works with many securities regulators and international organizations, including the IOSCO, to improve global transparency and disclosure, strengthen the supervision of global firms and markets, reinforce regulatory standards, and enhance cross-border enforcement cooperation. SEC staff has also engaged in bilateral regulatory dialogues with foreign regulators in order to explore common approaches for regulating market participants operating on a cross-border basis.

INITIATIVE	FY05	FY06 PLAN	FY06 ACTUAL
Eliminating GAAP reconciliation requirement for foreign issuers using International Financial Regulatory Standards (IFRS)	"Road map" published by SEC staff	Begin reviewing the consistency of foreign private issuers' 2005 IFRS financial statements and accompanying reconciliations	Began reviewing the consistency of foreign private issuers' 2005 IFRS financial statements and accompanying reconciliations; agreed to cooperate with the Committee of European Securities Regulators (CESR) with respect to the application by internationally active companies of IFRS and Generally Accepted Accounting Principles (GAAP) in the United States and the European Union
Bilateral regulatory dialogues	Launched dialogues with the China Securities Regulatory Commission and Japan's Financial Services Authority; Ongoing dialogues with the European Commission and CESR	Ongoing	Ongoing; launched a dialogue with the Korea Financial Supervisory Commission; adopted joint work plan with CESR focusing on consistent application of IFRS, modernization of disclosure technology, and regulatory platforms for risk management
All IOSCO jurisdictions to be accepted as signatories or to express a commitment to seek legal authority to become signatories to the Multilateral Memorandum of Understanding on Enforcement Cooperation and Information-Sharing	Total of 28 jurisdictions accepted as signatories; agreed on target date of 2010 for 80 more jurisdictions	Additional jurisdictions accepted, with progress toward goal of adding 80 more jurisdictions by 2010	Total of 34 jurisdictions accepted as signatories
IOSCO initiative on preservation and repatriation of property in cross-border cases	Analyzed powers available to regulators and other authorities within jurisdictions to freeze and repatriate assets	Support a resolution by IOSCO calling for jurisdictions to examine the legal framework and strive to develop mechanisms, including legislative reform, to freeze assets on behalf of a foreign regulator	Resolution adopted; contributed to guidance to IOSCO members on procedural and substantive issues related to implementation, including range of potential approaches

INITIATIVE	FY05	FY06 PLAN	FY06 ACTUAL
IOSCO action plan to strengthen global capital markets against financial fraud	Established a dialogue with regulators in priority jurisdictions to develop a mutual understanding of their willingness and ability to share information	To be determined upon receipt and analysis of commitments from priority jurisdictions	Ongoing dialogue with regulators in priority jurisdictions; worked on identifying a second group of priority jurisdictions
IOSCO action plan to strengthen global capital markets against financial fraud	Initiated work to identify trends with regard to recent audit failures	Contribute to a report on trends with regard to recent audit failures	Contributed to reports on global auditor standards and to development of work on audit quality and contingency planning for audit firm failures
IOSCO action plan to strengthen global capital markets against financial fraud	Undertook a study of issuer internal control require-ments in specified jurisdictions	Contribute to fact-finding report regarding issuer internal control requirements in specified jurisdictions	Contributed to fact-finding report regarding issuer internal control requirements in specified jurisdictions
IOSCO action plan to strengthen global capital markets against financial fraud	Identified best practices for improving bond market transparency	Identified best practices for improving bond market transparency	Undertook a study of bond market practices and arrived at a preliminary assessment of areas for improvement
IOSCO action plan to strengthen global capital markets against financial fraud	Reviewed the role played by market intermediaries in recent financial scandals	Complete review and, if necessary, contribute to developing a set of best practices for addressing conflicts of interest	Completed review of the role played by market intermedi-aries in recent financial scandals; initiated additional work on the topic of information management in the context of conflict; contributed to a discussion paper on addressing conflicts of interest

ANALYSIS OF RESULTS: The Commission and staff pursued a number of far-reaching objectives with other regulators designed to improve investor protection and strengthen global capital markets. For FY 2006, these efforts included launching a bilateral regulatory dialogue with the Korea Financial Supervisory Commission and continuing dialogues with the China Securities Regulatory Commission, Japan's Financial Services Authority, and the European Commission and CESR; adopting a joint work plan with CESR focusing on consis-tent application of IFRS, modernization of disclosure technology, and regulatory platforms for risk management; and encouraging IOSCO members to develop mechanisms to assist foreign counterparts in freezing assets derived from illegal activity. In addition, the Office of International Affairs continued a dialogue, through IOSCO, with securities regulators in priority jurisdictions to raise standards of cross-border enforcement cooperation.

***Outcome 2.3** Regulations are clearly written, flexible, and relevant, and do not impose unnecessary financial or reporting burdens.*

EXHIBIT 2.6
PERFORMANCE MEASURE:

Percentage of Responses to Exemptive, No-Action Letter, and Interpretive Requests Issued Within Six Months

DESCRIPTION: The SEC responds to inquiries from individuals or companies about whether an activity undertaken in a specified manner would violate the securities laws. The inquiries take the form of written requests that the staff not recommend enforcement or other action to the Commission if the activity is completed as specified. The originators of "no-action" requests submit their inquiries privately, but the SEC publicly releases both the request and its response upon completion. SEC staff also respond to requests to interpret specific provisions of the securities rules and review applications for exemptions from the securities laws.

FY04	FY05	FY06 PLAN	FY06 ACTUAL
84%	89%	85%	85%

ANALYSIS OF RESULTS: The Divisions of Market Regulation, Corporation Finance, and Investment Management collectively met their target for providing timely responses to requests received for exemptive relief and interpretive or no-action advice.

EXHIBIT 2.7
PERFORMANCE MEASURE:

Percentage of SRO Rule Filings Closed in Less Than 60 Days

DESCRIPTION: SRO rule changes are reviewed for consistency with investor protection and market operation and structure rules that govern the operation of registered national securities exchanges, clearing agencies, and the automated quotation systems operated by the NASD and Municipal Securities Rulemaking Board. The figures below represent the percentage of proposed SRO rule changes reviewed (i.e., approved or disapproved) within 60 days from receipt of the last amendment filed by the SRO.

FY03	FY04	FY05	FY06 PLAN	FY06 ACTUAL
74%	78%	80%	75%	84%

ANALYSIS OF RESULTS: In light of the increasingly competitive and rapidly changing financial markets, as well as the relatively few new market developments requiring immediate responses, the Division of Market Regulation has been able to expedite its reviews of SRO rule changes. Staff also has improved its communication with SRO staff, resulting in fewer complications with proposed SRO rule changes.

Goal 3: Foster Informed Investment Decision Making

Outcome 3.1 *Investors have accurate, adequate, and timely public access to disclosure materials that are useful and can be easily understood and analyzed across companies, industries, or funds.*

EXHIBIT 2.8
PERFORMANCE MEASURE:

Percentage of Investment Adviser and Investment Company Transactional Reviews Completed Within Timeliness Goals

DESCRIPTION: For initial registration statements, the SEC's goal is to comment within 30 days after they are filed. (The agency's goal is 60 days for registration statements of insurance product separate accounts.) The SEC also aims to comment on post-effective amendments within 45 days and preliminary proxy statements within 10 days after they are filed.

	FY03	FY04	FY05	FY06 PLAN	FY06 ACTUAL
Initial Registration Statements	81%	88%	90%	85%	88%
Post-Effective Amendments	86%	98%	97%	90%	96%
Preliminary Proxy Statements	100%	100%	100%	99%	99%

ANALYSIS OF RESULTS: The SEC exceeded its FY 2006 goals for timeliness, reviewing 88 percent of initial registration statements, 96 percent of post-effective amendments, and 99 percent of preliminary proxy statements within the agency's targeted timeframes.

EXHIBIT 2.9
PERFORMANCE MEASURE:

Average Time to Issue Initial Comments on Securities Act Filings

DESCRIPTION: The target of 30 days has become a de facto industry standard for the maximum time to receive SEC comments. Companies often build this timeframe into their plans. The 30-day timeframe is considered aggressive, given the other mandatory reviews the Commission conducts and the fluctuation in filing volume that impacts workload plans.

FY03	FY04	FY05	FY06 PLAN	FY06 ACTUAL
27.7 days	27.8 days	26.1 days	<30 days	26.2 days

ANALYSIS OF RESULTS: The Division of Corporation Finance issued initial comments on 1933 and 1934 Act registration statements within an average of 26 days of filing, significantly less than its target goal of 30 days. In addition, the Division continued to monitor the average duration between the moment it receives a company response on the SEC staff's initial comments and final resolution, and the Division has worked to decrease the amount of time attributed to staff review.

EXHIBIT 2.10
PERFORMANCE MEASURE:

Annual Number of Online Searches for EDGAR Filings

DESCRIPTION: Greater availability of market-sensitive information through the SEC's EDGAR system provides investors with the ability to make better-informed investment decisions. This measure gauges the demand for EDGAR data through the SEC's website (searches in millions).

FY02	FY03	FY04	FY05	FY06 PLAN	FY06 ACTUAL
97	142	289	379	480	528

ANALYSIS OF RESULTS: The demand for the disclosure data from EDGAR increased as the agency continued to improve the system through the interactive data, EDGAR ticker, and full-text search initiatives, making the information much more useful and analyzable for investors.

See also *Section 1: Management's Discussion and Analysis, Exhibit 1.4: Percentage of Reporting Companies and Investment Companies with Disclosures Reviewed by the SEC* and *Exhibit 1.5: Percentage of Forms and Submissions Filed Electronically and in a Structured Format.*

Outcome 3.2 *Investors have a better understanding of the operations of the nation's securities markets.*

EXHIBIT 2.11
PERFORMANCE MEASURE:

Number and Percentage of Investor Complaints, Questions, and Requests Completed by the Office of Investor Education and Assistance (OIEA) Within Seven Calendar Days

DESCRIPTION: OIEA serves the tens of thousands of investors who contact the SEC each year with investment-related complaints and questions. A substantial portion of the complaints received require input from the entities involved and cannot be resolved in less than 30 to 60 days. Nevertheless, the staff aim to close out as many new matters as possible within seven calendar days.

	FY02	FY03	FY04	FY05	FY06 PLAN	FY06 ACTUAL
Contacts received	82,337	70,574	73,481	76,221	76,000	77,274
Unique files opened	81,748	71,373	73,415	71,737	71,000	69,628
Unique files closed	n/a	n/a	n/a	71,879	71,000	69,507
Closed within seven calendar days	64,818	58,133	60,688	58,443	58,000	56,268
Percentage	79%	81%	83%	81%	82%	81%

ANALYSIS OF RESULTS: During FY 2006, OIEA continued its transition to a new correspondence management system that no longer records each investor contact as a unique file. As a result, the number of new unique files fell despite a slight increase in the volume of investor contacts.

EXHIBIT 2.12
PERFORMANCE MEASURE:

OIEA Publications Distributed by the General Services Administration (GSA)

DESCRIPTION: OIEA has developed an extensive collection of free information to help investors understand the basics of investing; the risks and rewards of various products and strategies; the importance of diversification; and how to obtain information about companies, brokers, and advisers. In addition to posting these materials on the SEC's website, OIEA publishes a dozen hard-copy educational brochures. The GSA's Federal Consumer Information Center (FCIC) serves as one of the most important distribution channels for the SEC's most popular English and Spanish publications.

FY02	FY03	FY04	FY05	FY06 PLAN	FY06 ACTUAL
81,917	89,095	300,530	476,095	325,000	300,136

ANALYSIS OF RESULTS: OIEA continued to create demand for the SEC's educational materials and work closely with GSA's FCIC to distribute hard copies of the materials at lower costs. OIEA nearly met its target in FY 2006.

Goal 4: Maximize the Use of SEC Resources

Outcome 4.1 *Human capital strategies are aligned to achieve SEC mission, goals, and outcomes.*

EXHIBIT 2.13
PERFORMANCE MEASURE:

Staff Turnover Rate

DESCRIPTION: This measure is determined by dividing the number of employees that leave the agency during the fiscal year by the total number of permanent and term employees on board at the beginning of the year.

FY02	FY03	FY04	FY05	FY06 PLAN	FY06 ACTUAL
5.8%	5.9%	6.3%	7.5%	<8%	9.1%

ANALYSIS OF RESULTS: The increase in the turnover rate in 2006 is largely due to a high number of retirements, as well as heightened competition from the private sector for experienced accountants. The agency is monitoring turnover very closely and will work to maintain and build upon its status as one of the top five places to work in the federal government (according to the Partnership for Public Service and *U.S. News & World Report*).

EXHIBIT 2.14
PERFORMANCE MEASURE:

Milestones Achieved on Major Human Capital Initiatives

DESCRIPTION: This chart outlines the SEC's progress in implementing initiatives to support integration of human capital systems and improve human resources policy development and oversight

	FY05	FY06 PLAN	FY06 ACTUAL
Integrated Human Capital Systems			
Competency-based performance management system*			Implemented
Pay for performance and performance improvement planning	Evaluated & Expanded	Evaluate, Revise, & Expand	Evaluated & Revised
Negotiate a new collective bargaining agreement		Negotiate & Implement	Negotiated (now before impasse panel)
SEC University (classroom and online courses)	Expanded	Evaluate & Expand	Revised & Expanded
Leadership and management development system*			Developed
Improve OHR human capital readiness*			Implemented
Knowledge management framework*			Developed
Marketing of OHR programs*			Developed
Workforce planning system*			Developed
Human capital measurement model*			Developed
National recruitment plan*			Developed
HR Policy Development and Oversight			
Optimize the use of AVUE	Evaluated	Evaluate	Evaluated & Expanded
Employee Benefits Information System (EBIS)*			Implemented
Pay and benefits revisions	Evaluated	Expand	Evaluated & Expanded
Administrative Officers' professional development*			Implemented
Enterprise telework program	Evaluated	Expand	Expanded
Intranet program guidance*			Developed
Process improvement and quality control system*			Developed

ANALYSIS OF RESULTS: OHR met or exceeded the targets for five of its six planned initiatives. In addition, OHR met milestones for twelve new initiatives that did not have established targets as of the beginning of FY 2006.

**New measure developed in 2006.*

Outcome 4.2 Financial management and internal controls are sound.

EXHIBIT 2.15
PERFORMANCE MEASURE:

Receive an Unqualified Audit Opinion on the SEC's Audited Financial Statements with No Material Weaknesses Noted in Internal Controls over Financial Reporting (ICFR)

DESCRIPTION: Under the Accountability of Taxpayer Dollars Act of 2002, the Commission is required to meet all proprietary accounting guidelines for federal agencies and to undergo annual audits. The SEC completed its first two audits in 2004 and 2005, conducted by the U.S. Government Accountability Office (GAO).

	FY04	FY05	FY06 PLAN	FY06 ACTUAL
Audit Opinion	Unqualified	Unqualified	Unqualified	Unqualified
Material Weaknesses in ICFR	3	3	0	0

ANALYSIS OF RESULTS: Aggressive remediation efforts have resolved three material weaknesses. Three reportable conditions will be resolved in FY 2007.

Outcome 4.3 Business improvements are promoted through the innovative use of information technology.

EXHIBIT 2.16
PERFORMANCE MEASURE:

Percentage of IT Projects That Adhere to the SEC's Capital Planning and Investment Control (CPIC) Process

DESCRIPTION: The SEC has information technology capital planning committees designed to ensure that IT projects are appropriately evaluated and considered. A corresponding CPIC process is being refined to ensure that IT projects are effectively managed, completed on time, and within budget. This measure identifies the percentage of IT projects that adhere to the agency's CPIC process.

FY04	FY05	FY06 PLAN	FY06 ACTUAL
100% of all IT projects	90% of all IT projects	100% of all IT projects	97% of all IT projects

ANALYSIS OF RESULTS: During FY 2006, 73 of 75 Office of Information Technology's investments went through the Commission's formal investment approval process (the "select" phase of the capital planning and investment control process). The remainder were approved by the Chief Information Officer, as required by the Clinger-Cohen Act, in order to meet short-term urgent needs.

EXHIBIT 2.17
PERFORMANCE MEASURE:

Milestones for Major IT Projects

DESCRIPTION: The following chart presents the SEC's major information technology initiatives, as well as the major milestones on those initiatives that were planned and achieved in FY 2006. A summary of this table is also shown in *Section 1, Exhibit 1.6.*

	FY05	FY06 PLAN	FY06 ACTUAL
(EDGAR)/Disclosure			
Modify EDGAR to accommodate interactive data in XBRL format for financial reports	Initiated	In progress	In progress
Transition EDGAR system management to new contract	Initiated	Completed	In progress
Enhance SEC.gov to improve EDGAR data searches and accessibility for investors	Initiated	In progress	In progress
Enforcement/Examination Activities			
Image backlog of paper-based discovery documents	In progress	Completed	In progress
Provide fully automated processing of options trade records in support of enforcement investigations	In progress	Completed	Completed
Redesign the enforcement case management system to improve management of penalties and disgorgement	Initiated	In progress	In progress
Upgrade analytical tools available to examiners	Initiated	In progress	In progress
Internal Productivity			
Implement new systems to support expansion of telework	In progress	Completed	Completed
Implement new procurement and budgeting/performance management systems	Initiated	In progress	In progress
Security/Disaster Recovery			
Certify and accredit major systems for information security risk	In progress	Completed	Completed
Implement Homeland Security Presidential Directive 12 for personnel identity verification and access control	Initiated	In progress	In progress
Electronic Government (e-Gov)/Enterprise Architecture and Capital Planning Investment Control			
Redesign capital planning and project management processes	In progress	Completed	Completed
Institute enterprise architecture (EA) program	In progress	Initiate	In progress
Upgrade core financial management capabilities and systems		Initiate	Initiated

ANALYSIS OF RESULTS: The SEC continued to make marked progress in all five areas to enhance program effectiveness and operational efficiencies, recognizing that the agency's IT priorities for the coming years will continue to evolve over time.

OTHER INDICATORS RELATED TO SEC ACTIVITIES

The following indicators are useful in understanding the SEC's activities but should not be considered performance measures, as they do not include targets that the agency will strive to reach in future years. In most cases, the SEC chose not to include targets for these indicators because they gauge the number of violations or "significant" deficiencies uncovered, and it would be inappropriate for the agency to conduct these activities with an eye toward hitting predetermined numerical targets, rather than evaluating the evidence as presented.

EXHIBIT 2.18
INDICATOR 1:

Number and Percentage of Examinations Finding "Significant" Deficiencies

DESCRIPTION: Examiners find a wide range of deficiencies during examinations. Some of these deficiencies are more technical in nature, such as failing to include all information that is required to be in a record. Other deficiencies may have caused harm to customers or clients of a firm, had a high potential to cause harm, or reflect recidivist misconduct. These latter deficiencies are among those categorized as "significant." This indicator was first implemented in FY 2005 and data is not available for prior years. The staff expects to continue to refine the factors that are used to measure the significance of examination findings.

	FY05	FY06
Fund/adviser exam significant findings		
Number	769	648
Percent	37%	39%
Broker/dealer exam significant findings		
Number	351	297
Percent	48%	40%

ANALYSIS OF RESULTS: Examiners continued to use risk-assessment techniques to focus examinations on areas most likely to reveal significant compliance issues. Examples of significant findings include findings that were referred to the Division of Enforcement for further investigation or situations in which examinations found violations that were the same as those found in a previous exam.

EXHIBIT 2.19
INDICATOR 2:

Referrals to the Division of Enforcement From the Office of Compliance Inspections and Examinations or the Division of Corporation Finance

DESCRIPTION: The SEC's Division of Enforcement receives referrals from a variety of sources. For example, the examination staff and the Division of Corporation Finance's disclosure review program strive to uncover serious potential violations of the federal securities laws, among other objectives. When possible violations are found, they are referred to the Division of Enforcement for further investigation. This indicator measures the number of enforcement referrals from the examination staff and the Division of Corporation Finance within each fiscal year.

	FY03	FY04	FY05	FY06
Examination staff	171	482	399	223
Corporation finance	231	415	640	537

ANALYSIS OF RESULTS: In general, the examination program and the Division of Corporation Finance uncovered fewer potential violations that warranted further investigation by the enforcement program. For the Division of Corporation Finance, the number of referrals in FY 2005 was unusually high because the Division identified a large number of issuers that failed to file required reports. For the Office of Compliance Inspections and Examinations, many referrals in 2004 and 2005 concerned market timing and late trading.

EXHIBIT 2.20
INDICATOR 3:

Monetary Disgorgement and Penalties Ordered and the Amounts and Percentage Collected by the SEC

DESCRIPTION: In addition to other types of relief, the Commission may seek orders requiring parties to disgorge any money obtained through wrongdoing. The Commission is also empowered to seek civil penalties for violations of the securities laws. Where appropriate, the Commission has sought to return disgorged funds to harmed investors and, as a result of the "fair funds" provision of the Sarbanes-Oxley Act, to use amounts paid as penalties to reduce losses to injured parties. Funds not returned to investors are sent to the Treasury; neither disgorgement nor penalties go to the SEC. This chart lists disgorgement and penalties ordered as a result of SEC cases and the amounts collected by the agency.

	FY03	FY04	FY05	FY06
Ordered	$.350 billion	$1.7 billion	$1.9 billion	$1.2 billion
Collected	$.141 billion	$1.4 billion	$1.8 billion	$.991 billion
Percentage	40%	86%	96%	82%

ANALYSIS OF RESULTS: The amount of penalties and disgorgement may vary widely from year to year, and the collection success rates depend on numerous variables, including the financial status and size of the parties sued.

EXHIBIT 2.21
INDICATOR 4:

Assets Frozen Abroad as a Result of SEC Coordination With Foreign Regulators

DESCRIPTION: In order to effectively enforce compliance with federal securities laws and in support of enforcement cases filed domestically, the SEC works closely with foreign regulators, law enforcement agencies, and courts to locate ill-gotten proceeds that have been transferred overseas and to freeze the accounts in which they are located. Violators are detected and their assets are seized so that they cannot benefit from this activity.

FY05	FY06
$15.3 million	$20.7 million

ANALYSIS OF RESULTS: The SEC cannot project future estimates for this indicator because it is impossible to predict the extent to which violators will move their ill-gotten proceeds to foreign jurisdictions. The SEC does anticipate that its efforts to freeze assets abroad will increase as international cooperation on enforcement matters develops around the globe.

EXHIBIT 2.22
INDICATOR 5:

Percentage of Households Owning Mutual Funds

DESCRIPTION: Near record numbers of Americans continue to invest in the U.S. securities markets through the purchase and sale of stocks, bonds, and mutual funds. In particular, the number and percentage of U.S. households that own mutual funds grew dramatically during the 1990s as stock and bond mutual funds became a key repository for U.S. savings dollars. These data are derived from a survey of approximately 3,000 households conducted by the Investment Company Institute. Results have a standard error of +/– 1.8 percent at the 95 percent confidence level. The sample is weighted to match the age distribution of the U.S. population. The number of U.S. households is based on the most recent estimate by the U.S. Bureau of the Census.

FY02	FY03	FY04	FY05	FY06
49.6%	47.9%	48.1%	47.5%	48%

ANALYSIS OF RESULTS: The proportion of households owning mutual funds held steady in FY 2005 relative to the previous two years.

EXHIBIT 2.23
INDICATOR 6:

Number of Corporate Disclosure Filings "Significantly" Improved by Staff Comments, and Number of "Significant" Actions Taken by Disclosure Review Staff to Protect Investment Company Shareholders

DESCRIPTION: For corporate filings, comments are issued to elicit better compliance with applicable disclosure requirements and improve the information available to investors. In many instances, amendments involve financial restatements. The determination of "significance" stems from the nature of the change (e.g., restating positive income as a loss) or the size of the company. With respect to investment company filings, the staff takes actions to elicit better compliance with applicable disclosure requirements, improve the information available to investors, and ensure that fund investment, marketing, and operational activities as described in disclosure documents are conducted in accordance with federal law.

ANALYSIS OF RESULTS: The Divisions of Corporation Finance and Investment Management continued to work toward establishing a means for accurately tracking data on comments that result in significant enhancements in financial and other disclosures or other significant actions to protect shareholders. The divisions will provide data for this indicator once such tracking methods are in place.

PRESIDENT'S MANAGEMENT AGENDA

The President's Management Agenda (PMA) consists of five government-wide initiatives to make government more citizen-centered, results-oriented, and market-based. These initiatives include:

- Strategic Management of Human Capital;
- Budget and Performance Integration;
- Expanded Electronic Government;
- Improved Financial Management; and
- Competitive Sourcing

The Commission, as an independent agency, actively addressed the PMA in the performance of its mission and worked to achieve the goals of the PMA through its planning and operations.

Strategic Human Capital Management

The SEC's Office of Human Resources (OHR) provides organizational leadership for the strategic management of the agency's human capital. OHR changed its focus in FY 2006 when it adopted a set of strategic initiatives in alignment with the President's Management Agenda and the Human Capital Assessment and Accountability Framework (HCAAF). OHR developed a strategy map and balanced scorecard to support effective execution of its strategy. The Office also developed a plan to organize its staff according to the HCAAF and expects to gradually implement the plan over the next two years. This approach has enhanced the Office's alignment of resources and fostered stronger partnerships throughout the agency.

Integrated Human Capital Systems. The SEC is committed to integrating its human capital systems such as selection, performance management, and employee development through competency-based workforce planning. To that end, the agency developed and began to implement a new competency-based performance management system that will be available to the entire agency by 2008. SEC University staff implemented targeted skill assessment and development strategies, established a process for curriculum development for leadership positions, and initiated plans for a comprehensive knowledge management program. The SEC University staff also began to revise and expand its e-learning platform to provide Continuing Professional Education (CPE) credits for the SEC's accountants.

HR Policy Development and Oversight. Telework participation increased significantly, from 23 percent of the agency's staff at the end of FY 2005 to 34 percent by the end of FY 2006. The SEC also built the foundations for a new childcare center at the agency's headquarters, by finalizing negotiations with the union related to the center, researching best practices for childcare centers, overseeing development of site architectural plans, and establishing a Board of Directors.

OHR successfully implemented the web-based Employee Benefits Information System (EBIS) across the SEC. The system includes retirement and benefit calculators, employee benefit offerings, and automated benefit and retirement forms for agency employees. OHR also successfully worked with OPM to gain Voluntary Early Retirement Authority (VERA) and Voluntary Separation Incentive Payments (VSIP) to help the agency strategically manage its attrition by targeting non-critical positions.

Expanding Electronic Government

Throughout FY 2006, the SEC continued to focus on expanding electronic government. Several of the SEC's strategic e-Gov initiatives are highlighted below:

Interactive data. The SEC has long promoted electronic filing and dissemination of corporate and mutual fund disclosure documents. Now, the SEC is beginning to employ interactive data standards such as eXtensible Business Markup Language (XBRL) to collect and transmit disclosure information in much more flexible and analyzable ways. Currently public companies and mutual funds can file their annual, quarterly, and current financial statements with the SEC in XBRL format. Going forward, the SEC plans to use web tools that will let investors and analysts use interactive data to analyze that information. The SEC's website will feature a variety of commercially available software products that will allow individual investors, analysts, and companies to quickly search for and analyze individual line items from financial statements and text-based information, including accounting policies or mutual fund expenses, and to easily compare them from company to company and industry to industry.

Additional website enhancements to promote disclosure. The SEC enhanced the agency's website by providing citizens the ability to perform full text searches of EDGAR filings. Public users also are afforded a "Really Simple Syndication" (RSS) feed, which distributes daily changes in all filings that are submitted in XRBL format. The website also provides users new tools for researching mutual funds, variable insurance products, and effectiveness notices.

New electronic filings and submissions. The SEC's e-Gov effort continues to focus on expanding the direct electronic submission of Bluesheets data by broker-dealers to the SEC and the electronic filing of forms by self-regulatory organizations (SROs) using the Commission's SRO Rule Tracking System (SRTS).

Document imaging. Another focus of the SEC's e-Gov efforts is the refinement of the document imaging and management process, which continues to eliminate printing costs to the regulated community and the time associated with the manual retrieval of over 42 million pages that the SEC now receives and stores electronically rather than on paper.

Federated identity management. The SEC's e-Gov initiatives also address the security and identity mandates outlined in Homeland Security Presidential Directive 12 (HSPD-12). The SEC's Federated Identity Management initiative provides an identity management solution that supports consistent processes for hiring and terminating contractors and staff. Overall, the agency anticipates that this initiative will result in significant security improvements, as well as greater efficiency and information sharing potential for SEC staff.

Improved Financial Management

In FY 2006, the SEC continued an energetic program to strengthen its financial management systems, consistent with the PMA. The SEC received an unqualified audit opinion on its financial statements for the third year in a row, and the agency resolved each of the three material weaknesses identified in previous audits.

The SEC made extensive improvements in its internal controls in the last year, with the introduction or enhancement of several new systems for managing the agency's administrative processes. In 2006, the agency's core financial system was upgraded and made more secure, and the SEC also introduced new systems for managing the procurement and budgeting process. In addition, the SEC undertook a major initiative to improve the management of disgorgements and penalties arising from its enforcement actions and implemented a number of management process changes; a system supporting these changes will be deployed in early FY 2007. The Commission also moved closer to producing information about the costs of achieving strategic goals. The activity-based costing functionality of the agency's new BPPAS system will enhance financial controls, allow more timely monitoring and analysis of current and projected operating budgets, and more accurately assign full costs to programs, offices, and performance measures.

A more detailed discussion of the SEC's internal controls and audit findings is located in *Section 1: Management's Discussion and Analysis and Section 3: Financial Section.*

Competitive Sourcing

The SEC did not conduct any competitions during FY 2006; however, the Commission is continuing to analyze data for the purpose of conducting competitions in FY 2007.

MESSAGE FROM THE CHIEF FINANCIAL OFFICER

Margaret J. Carpenter
Associate Executive
Director, Finance

I am pleased to present the SEC's Performance and Accountability Report for FY 2006. This is the third year that this agency has prepared audited financial statements and a full PAR. I am gratified to report that the auditors, the U.S. Government Accountability Office, issued a third unqualified opinion on the SEC's statements.

The agency successfully resolved material weaknesses in internal controls over financial reporting in three key areas: preparation of financial statements, recording and reporting of disgorgement and penalties, and information security. In FY 2007, the Financial Management Oversight Committee and other agency managers will address the remaining risks related to disgorgement and penalties, IT security, and property and equipment. Management also will work to ensure that all new internal control processes can be effectively sustained and reinforced.

The SEC must continue to strengthen and streamline program and financial operations in order to fully integrate financial management and reporting requirements into all operations. These changes will include both enhancements to information technology systems and reinforcement of operational policies and procedures. In FY 2006, the SEC initiated implementation of new procurement and performance budgeting systems. In FY 2007, we will implement new cost accounting, e-travel, and disgorgement and penalties financial management systems, and we will begin to assess options for upgrading the central accounting system. The latter is particularly critical for improving the efficiency of our financial reporting program.

Our primary financial management goal is to strengthen SEC financial systems to efficiently support the achievement of the agency's critical missions by providing accurate and timely financial information that is available to management to inform decision making and influence results. This year's notable progress in strengthening internal controls and the successful completion of the third annual audit and PAR reflect a productive collaboration by many dedicated and dynamic SEC staff and demonstrate our capability to fully achieve this financial management goal.

M J Carpenter

Margaret J. Carpenter
Associate Executive Director
Finance
November 2006

U.S. SECURITIES AND EXCHANGE COMMISSION

Balance Sheets

As of September 30, 2006 and 2005

(DOLLARS IN THOUSANDS)	2006	2005
ASSETS		
Intragovernmental:		
Fund Balance with Treasury (Notes 1-K and 2)	$5,178,893	$4,348,936
Investments (Notes 1-L, 5 and 19)	3,674,528	1,768,024
Accounts Receivable (Notes 1-E, 1-M, and 6)	154,506	194
Total Intragovernmental	9,007,927	6,117,154
Cash (Notes 1-O and 4)	—	9
Accounts Receivable, Net (Notes 1-E, 1-M, and 6)	177,491	222,401
Advances and Prepayments (Note 1-N)	974	657
Property and Equipment, Net (Notes 1-P and 7)	103,631	73,309
Total Assets	$9,290,023	$6,413,530
LIABILITIES		
Intragovernmental:		
Accounts Payable (Notes 1-Q and 8)	$ 14,527	$ 16,848
Employee Benefits (Notes 1-T and 8)	2,687	2,702
Unfunded FECA Liability (Notes 1-R, 8, and 17)	992	1,045
Total Intragovernmental	18,206	20,595
Accounts Payable (Notes 1-Q and 8)	47,608	28,014
Accrued Payroll and Benefits (Notes 1-Q and 8)	18,149	18,436
Accrued Leave (Notes 1-S, 8, and 17)	32,974	32,024
Registrant Deposits (Notes 1-I, 3, and 8)	57,464	65,934
Actuarial FECA Liability (Notes 1-R, 8, 9, and 17)	4,813	5,475
Fiduciary Liability (Notes 1-W, 3, 8, and 19)	3,834,662	1,975,553
Custodial Liability (Notes 1-V, 3, 8, and 18)	71,545	95,512
Other Accrued Liabilities (Notes 8 and 10)	42,480	28,670
Total Liabilities	4,127,901	2,270,213
Commitments and Contingencies (Notes 8 and 20)		
NET POSITION		
Unexpended Appropriations—Other Funds	9,201	9,791
Cumulative Results of Operations—Other Funds	5,152,921	4,133,526
Total Net Position	5,162,122	4,143,317
Total Liabilities and Net Position	$9,290,023	$6,413,530

The accompanying notes are an integral part of these financial statements.

Statements of Net Cost

For the years ended September 30, 2006 and 2005

(DOLLARS IN THOUSANDS)	2006	2005
PROGRAM COSTS (Notes 12 and 13)		
Compliance Inspections and Examinations		
Gross Cost	$ 241,197	$ 248,972
Corporation Finance		
Gross Cost	125,483	127,631
Enforcement		
Gross Cost	336,726	364,515
Investment Management		
Gross Cost	50,512	49,408
Market Regulation		
Gross Cost	46,889	46,484
Other Offices		
Gross Cost	88,116	80,640
TOTAL ENTITY		
Total Gross Program Cost	888,923	917,650
Less: Earned Revenue Not Attributed to Programs (Note 14)	(1,882,619)	(1,745,111)
Net (Income) from Operations	$ (993,696)	$ (827,461)

The accompanying notes are an integral part of these financial statements.

Statements of Changes in Net Position

For the years ended September 30, 2006 and 2005

(DOLLARS IN THOUSANDS)	2006	2005
CUMULATIVE RESULTS OF OPERATIONS		
Beginning Balance	$4,133,526	$3,290,288
Budgetary Financing Sources:		
Appropriations Not Available	(1,151)	(10,055)
Other Financing Sources:		
Imputed Financing (Note 11)	26,850	25,832
Total Financing Sources	25,699	15,777
Net Income from Operations—Other Funds	993,696	827,461
Net Change—Other Funds	1,019,395	843,238
Cumulative Results of Operations	5,152,921	4,133,526
UNEXPENDED APPROPRIATIONS		
Beginning Balance	9,791	313
Budgetary Financing Sources:		
Appropriations Not Available	(590)	9,478
Total Unexpended Appropriations	9,201	9,791
Net Position, End of Period—Other Funds	$5,162,122	$4,143,317

The accompanying notes are an integral part of these financial statements.

Statements of Budgetary Resources

For the years ended September 30, 2006 and 2005

(DOLLARS IN THOUSANDS)	2006	2005
BUDGETARY RESOURCES		
Unobligated Balance, Brought Forward, October 1	$3,840,573	$3,049,337
Recoveries of Prior Year Unpaid Obligations	32,410	87,608
Budget Authority:		
Spending Authority from Offsetting Collections:		
Earned		
Collected	1,903,648	1,665,560
Change in Receivables from Federal Sources	(63)	(24)
Change in Unfilled Customer Orders Without Advance Received	663	—
Subtotal	1,904,248	1,665,536
Nonexpenditure Transfers, Net, Anticipated and Actual (Note 15)	—	—
Temporarily Not Available Pursuant to Public Law	—	—
Permanently Not Available	(1,740)	(575)
Total Budgetary Resources	$5,775,491	$4,801,906
STATUS OF BUDGETARY RESOURCES		
Obligations Incurred:		
Direct (Note 16)	$ 896,911	$ 960,753
Reimbursable (Note 16)	519	580
Unobligated Balance Available:		
Realized and Apportioned for Current Period	14,978	39,224
Exempt From Apportionment	—	—
Unobligated Balance Not Available		
Restricted Funds	4,752,857	3,703,675
Expired Funds	110,226	97,674
Total Status of Budgetary Resources	$5,775,491	$4,801,906
CHANGE IN OBLIGATED BALANCE		
Obligated Balance, Net		
Unpaid Obligations, Brought Forward, October 1	$ 235,702	$ 228,680
Less: Uncollected Customer Payments from Federal Sources, Brought Forward, October 1	(194)	(219)
Total Unpaid Obligated Balance, Net	235,508	228,461
Obligations Incurred Net	897,430	961,333
Less: Gross Outlays	(870,620)	(866,702)
Less: Recoveries of Prior Year Unpaid Obligations, Actual	(32,410)	(87,609)
Change in Uncollected Customer Payments from Federal Sources	(600)	25
Obligated Balance, Net, End of Period Unpaid Obligations	230,102	235,702
Less: Uncollected Customer Payments from Federal Sources	(794)	(194)
Total, Unpaid Obligated Balance, Net, End of Period (Note 20)	$ 229,308	$ 235,508
NET OUTLAYS		
Net Outlays:		
Gross Outlays	$ 870,620	$ 866,702
Less: Offsetting Collections	(1,903,648)	(1,665,560)
Less: Distributed Offsetting Receipts	51,294	—
Net Outlays	$ (981,734)	$ (798,858)

The accompanying notes are an integral part of these financial statements.

Statements of Financing

For the years ended September 30, 2006 and 2005

(DOLLARS IN THOUSANDS)	2006	2005
RESOURCES USED TO FINANCE ACTIVITIES		
Budgetary Resources Obligated:		
Obligations Incurred (Note 16)	$ 897,430	$ 961,333
Less: Spending Authority from Offsetting Collections and Recoveries	(1,936,658)	(1,753,144)
Net Obligations	(1,039,228)	(791,811)
Other Resources:		
Imputed Financing from Cost Absorbed by Others (Note 11)	26,850	25,832
Total Resources Used to Finance Activities	(1,012,378)	(765,979)
RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST OF OPERATIONS		
Change in Budgetary Resources Obligated for Goods, Services and Benefits Ordered but Not Yet Provided	21,831	17,161
Resources that Finance the Acquisition of Assets Capitalized on the Balance Sheet	(57,658)	(42,081)
Net Decrease in Revenue Receivables Not Generating Resources until Collected	20,941	—
Total Resources Used to Finance Items not Part of the Net Cost of Operations	(14,886)	(24,920)
Total Resources Used to Finance the Net Cost of Operations	(1,027,264)	(790,899)
COMPONENTS OF NET COST OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD		
Components Requiring or Generating Resources in Future Periods:		
Costs That Will Be Funded by Resources in Future Periods (Note 17)	950	3,318
Net Increase in Revenue Receivables Not Generating Resources until Collected	—	(79,667)
Change in Lease Liability (Note 17)	5,994	21,647
Change in Unfunded FECA Liability (Note 17)	(715)	259
Total Components of Net Cost of Operations That Will Require or Generate Resources in Future Periods	6,229	(54,443)
Components Not Requiring or Generating Resources:		
Depreciation and Amortization	26,265	17,574
Revaluation of Assets or Liabilities	1,071	300
Other Costs That Will Not Require Resources	3	7
Total Components of Net Cost of Operations That Will Not Require or Generate Resources	27,339	17,881
Total Components of Net Cost of Operations That Will Not Require or Generate Resources in the Current Period	33,568	(36,562)
Net (Income) from Operations	$ (993,696)	$ (827,461)

The accompanying notes are an integral part of these financial statements.

Statements of Custodial Activity

For the years ended September 30, 2006 and 2005

(DOLLARS IN THOUSANDS)	2006	2005
REVENUE ACTIVITY		
Sources of Cash Collections:		
Disgorgement and Penalties	$1,804,043	$1,606,274
Other	90	270
Net Collections	1,804,133	1,606,544
Accrual Adjustments	(23,967)	(183,542)
Total Custodial Revenue (Notes 1-V and 18)	$1,780,166	$1,423,002
DISPOSITION OF COLLECTIONS		
Amounts Transferred to:		
Department of the Treasury	$ 122,030	$ 206,984
Fiduciary Fund	1,573,589	1,097,608
Public	108,514	301,952
Net Disbursements	1,804,133	1,606,544
Change in Liability Accounts	(23,967)	(183,542)
Total Disposition of Collections (Notes 1-V and 18)	$1,780,166	$1,423,002
NET CUSTODIAL ACTIVITY	$ —	$ —

The accompanying notes are an integral part of these financial statements.

Note 1. Summary of Significant Accounting Policies

A. Reporting Entity

The United States Securities and Exchange Commission (SEC) is an independent agency of the United States established pursuant to the Securities Exchange Act of 1934. The SEC's mission is to protect investors; maintain fair, orderly, and efficient securities markets; and facilitate capital formation. The SEC works with the Congress, other Executive Branch departments and agencies, self-regulatory organizations (SROs) (e.g., stock exchanges and the National Association of Securities Dealers), the Public Company Accounting Oversight Board, state securities regulators, and many other organizations in support of the agency's mission.

These financial statements report on the SEC's six major program areas: Compliance Inspections and Examinations; Corporation Finance; Enforcement; Investment Management; Market Regulation; and Other Offices. These programs promote the public interest by, among other activities: promoting compliance through inspections and examinations of regulated entities; facilitating capital formation through full disclosure; enforcing the federal securities laws; regulating investment companies and investment advisors; overseeing the operations of the nation's securities markets and participants; promoting technological innovation in the securities markets; encouraging international regulatory and enforcement cooperation; and educating and assisting investors.

B. Fund Accounting Structure

These financial statements present the SEC's individual funds and accounts. The SEC is classified in the Other Independent Agencies section of the federal budget. The SEC's financial activities are accounted for by Treasury account fund symbol, summarized as follows:

- ***Special Fund Receipts*** (X0100) include the appropriated general funds used to carry out the SEC's missions and functions for fiscal years (FY) 2006 and 2005 and revenues collected by the SEC in excess of appropriated funds (See *Note 2. Fund Balance With Treasury).*

- ***Salaries and Expenses*** (0100) include the appropriated general funds used to carry out the SEC's missions and functions for FY 2001 through 2004.

- ***Deposit Funds*** (X6563, F3875 and F3880) account for disgorgement, penalties, and interest collected and held on behalf of harmed investors, registrant monies held temporarily until earned by the SEC, and collections awaiting disposition or reclassification.

- ***Miscellaneous Receipt Accounts*** (1099 and 3220) hold non-entity receipts and accounts receivable from SEC custodial activities that cannot be deposited into funds under SEC control. These include amounts received pursuant to enforcement cases that are to be sent to the Treasury.

The SEC does not have lending or borrowing authority, except as discussed in *Note 20. Commitments and Contingencies.* The SEC does have custodial and fiduciary responsibilities, as described in *Note 18. Custodial Revenues and Liabilities* and *Note 19. Fiduciary Assets and Liabilities.*

C. Intra- and Inter-Agency Relationships

The SEC does not transact business among its own operating units, and therefore, intra-entity eliminations are not necessary. The SEC does have certain oversight responsibilities with respect to the Financial Accounting Standards Board (FASB); the Securities Investor Protection Corporation (SIPC) (See *Note 20. Commitments and Contingencies);* and the Public Company Accounting Oversight Board.

These entities have been excluded from the SEC reporting unit and the accompanying financial statements.

D. Basis of Presentation

The accompanying financial statements present the financial position, net cost of operations, changes in net position, budgetary resources, financing, and custodial and fiduciary activities of the SEC's core business activities in conformity with accounting principles generally accepted in the United States and Office of Management and Budget (OMB) Circular A-136, *Financial Reporting Requirements.* They may differ from other financial reports submitted pursuant to OMB directives for the purpose of monitoring and controlling the use of SEC budgetary resources. The SEC's books and records serve as the source of the information presented in the accompanying financial statements. Assets, liabilities, revenues, and costs have been classified in these financial statements according to the type of entity associated with the transactions. Intragovernmental assets and liabilities are those from or to other federal entities. Intragovernmental earned revenues are collections or accruals of revenue from other federal entities, and intragovernmental costs are payments or accruals to other federal entities. In addition, certain information is presented differently than the SEC's FY 2005 Performance and Accountability Report to conform to new reporting requirements in OMB A-136.

E. Change in Accounting Method

Effective June 30, 2006, the SEC implemented a new method for writing off debts that are two or more years old. This method is intended to incorporate additional requirements contained in OMB Circular A-129, *Policies for Federal Credit Programs and Non-Tax Receivables,* into the SEC's existing policy that called for reserving 100 percent of amounts more than two years old. The new write-off method calls for the SEC to write off debts that are two or more years old by removing the amount of the debts from the gross accounts receivable and any related allowance for doubtful accounts. This write-off policy is consistent with prior SEC policy on the calculation of the allowance for doubtful accounts, which called for a 100 percent reserve of any debt that was two or more years old, as discussed in *Note 1. M. Accounts Receivable and Allowance for Uncollectible Accounts.*

The effect of the new write-off method did not impact the net accounts receivable balance presented in the Balance Sheet because the prior policy on the calculation of the allowance for doubtful accounts resulted in the same net accounts receivable balance as the new method. By implementing the new method, the SEC removed $1,081 million of debts as well as the corresponding allowance for doubtful accounts. The effect of this change in accounting method is seen in the September 30, 2006 balance of gross accounts receivable and the related allowance for disgorgements and penalties shown in *Note 6. Accounts Receivable, Net.*

F. Basis of Accounting

Transactions are recorded on the accrual and budgetary bases of accounting. Accrual accounting requires revenue to be recognized when earned and expenses to be recognized when goods or services are received without regard to the receipt or payment of cash. Budgetary accounting facilitates compliance with the requirements for and controls over the use of federal funds.

The accompanying financial statements are presented in conformity with accounting principles generally accepted in the United States. The accounting principles and standards applied in preparing these financial statements are in accordance with the accounting policies and practices summarized in this note and the following hierarchy of accounting principles:

- Federal Accounting Standards Advisory Board (FASAB) Statements and Interpretations, and American Institute of Certified Public Accountants (AICPA) and FASB pronouncements, if made applicable to federal governmental entities by a FASAB Statement or Interpretation;
- FASAB Technical Bulletins and the following pronouncements, if specifically made applicable to federal government entities by the AICPA and cleared by the FASAB: AICPA Industry Audit and Accounting Guides and AICPA Statements of Position;
- AICPA Accounting Standards Executive Committee Practice Bulletins, if specifically made applicable to federal governmental entities and cleared by the FASAB and Technical Releases of the Accounting and Auditing Policy Committee of the FASAB;
- Implementation guides published by the FASAB staff and practices that are widely recognized and prevalent in the federal government; and
- Other accounting literature published by authoritative standard-setting bodies and other authoritative sources (a) in the absence of other guidance in the first four parts of this hierarchy, and (b) if the use of such accounting principles improves the meaningfulness of the financial statements.

G. Budgets and Budgetary Accounting

The SEC collects a variety of fees pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934, which the agency can use to offset its appropriated funds. These include securities transaction fees paid by the exchanges, and securities registration, tender offer, merger, and other fees paid by issuers. The National Securities Market Improvement Act of 1996 provided for reductions in pre-existing fee rates, and required future annual reductions in fee rates. The Investor and Capital Markets Fee Relief Act of 2002 requires the SEC to adjust fee rates each year through FY 2011, and to make a final adjustment to fix the fee rates for FY 2012 and beyond.

The SEC is subject to certain restrictions on its use of statutory fees. All fee revenues are deposited in a special fund receipt account at the United States Department of the Treasury. However, the SEC may use funds from this account only as authorized by Congress, made available by OMB apportionment, and upon issuance of a Treasury warrant. Revenue collected in excess of appropriated amounts is restricted for use by the SEC.

Fees other than the restricted excess fees can be used for SEC operations subject to an annual congressional limitation of $888.7 million and $913.6 million for the budget FY 2006 and 2005, respectively. Funds appropriated but not used in a given fiscal year are held in the special fund receipt account for use in future periods, as appropriated by the Congress.

Each fiscal year, the SEC receives its appropriation through Category A apportionments, which are quarterly distributions of budgetary resources made by OMB. The SEC also receives a small amount of Category B funds, which are exempt from quarterly apportionment.

H. Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from estimates contained in the accompanying financial statements.

I. Revenue and Other Financing Sources

The SEC's revenue and financing sources include exchange revenues, which are generated from arm's length transactions, and non-exchange revenues, which arise from the government's ability to demand payment. The SEC's exchange revenues consist of mainly fees collected from SROs and registrants. The SEC's non-exchange revenues consist of amounts collected in enforcement proceedings from violators of securities laws.

The SEC's funding is through primarily the collection of securities transaction fees from SROs, and securities registration, tender offer, merger, and other fees from registrants. The SEC's fee rates are established by law and are applied to volumes of activity reported by SROs or to filings submitted by registrants. When received, these fees are recorded as exchange revenue. The SEC is permitted by law to include these amounts in its obligational authority or to offset its expenditures and liabilities upon collection up to authorized limits. All amounts remitted by registrants in excess of the fees for specific filings are recorded as liabilities in deposit accounts until earned by the SEC from registrant filings or returned to the registrant pursuant to SEC policy, which calls for the return of registrant deposits when an account is dormant for six months.

The SEC also recognizes revenue from enforcement proceedings that result in the assessment of disgorgement, penalties, and interest against violators of federal securities laws. This activity is recognized as non-exchange revenue and presented on the Statement of Custodial Activity. When the SEC collects this revenue, it is either transferred to the Treasury or it is held by the SEC in a fiduciary capacity on behalf of harmed investors to whom the SEC intends to return the funds. An equal and offsetting liability for the fiduciary assets held by the SEC is reported on the Balance Sheet. The SEC does not record fiduciary assessments collected and held by another government entity, such as a court registry, or a non-government entity, such as a receiver.

In addition, the SEC's share of the cost to the federal government for providing pension and other post-retirement benefits to eligible SEC employees is recognized as an imputed financing source, as discussed further in *Note 11. Imputed Financing*. The SEC may also receive some gifts-in-kind that are used for primarily official travel to further the SEC's mission and objectives.

J. Entity/Non-Entity Assets

Assets that an agency is authorized to use in its operations are entity assets. Assets that are held by the SEC on behalf of another federal agency or a third party, and are not available for the agency's use, are non-entity assets. The SEC's non-entity assets include the following: (i) fiduciary assets, representing disgorgement, penalties, and interest collected and held or invested by the SEC pending distribution to harmed investors; (ii) custodial accounts receivable in respect of disgorgement, penalties, and interest owed by securities law violators; and (iii) registrant deposits, representing excess filing fees remitted by registrants.

K. Fund Balance With Treasury

Fund Balance With Treasury includes unrestricted balances that are available to finance the SEC's expenditures and restricted balances that cannot be used without further authorization by the United States Congress and apportionment by OMB.

Fund Balance With Treasury also includes certain funds held on behalf of third parties. These include registrant deposits, representing excess filing fees remitted by registrants, and uninvested fiduciary assets, representing disgorgement, penalties, and interest held by the SEC pending distribution to harmed investors.

All SEC banking activity is conducted in accordance with directives issued by the Treasury, Financial Management Service (FMS). All revenue and receipts are deposited in commercial bank accounts maintained by the FMS or wired directly to a Federal Reserve Bank. The Treasury processes all disbursements made by the SEC. All moneys maintained in commercial bank accounts are transferred to the Federal Reserve Bank on the next business day following the day of deposit.

L. Investments

The SEC's policy is to invest fiduciary assets in short-term Treasury securities, whenever practicable. These assets include disgorgement, penalties, and interest amounts that are collected from securities law violators and held for future distribution to harmed investors. Once these funds are collected, they are generally transferred to the SEC's deposit fund account and invested in short-term market-based Treasury bills through a facility provided by the Treasury, Bureau of the Public Debt (BPD), pending their distribution to investors. Interest earned is added to the funds available for distribution to investors.

M. Accounts Receivable and Allowance for Uncollectible Accounts

Entity and non-entity accounts receivable consist of amounts due primarily from the public.

Entity accounts receivable are amounts that will be retained by the SEC upon collection. These generally include claims arising from: (i) securities transaction fees paid by exchanges; (ii) filing fees paid by registrants; (iii) goods or services that the SEC has provided to another federal agency pursuant to an inter-agency agreement; (iv) host reimbursement of SEC employee travel; and (v) other employee-related debt. Entity accounts receivable represent a small portion of the SEC's business activities because agency fee legislation generally requires payment of filing fees at the time of filing, and SRO transaction fees are payable to the SEC twice a year—in March for the period September through December, and in September for the period January through August. Accordingly, the year-end accounts receivable generally represent only fees payable by the SROs to the SEC for activity during the month of September.

Non-entity accounts receivable are amounts that will not be retained by the SEC upon collection. These mainly include disgorgement, penalties, and interest assessed against violators of federal securities laws. These accounts receivable are recognized when the SEC is designated in an order of the Commission or a court to collect the assessed disgorgement, penalties, and interest. SEC maintains a custodial responsibility over these non-entity accounts receivable. When collected, these funds are either transferred to the Treasury, or they are held for future distribution to harmed investors.

The SEC is also party to orders directing the court or a receiver to collect the disgorgement, penalties, and interest assessed against violators of federal securities laws. These orders are not recognized as accounts receivable by the SEC because the debts are payable to another party. However, these debts are subject to change based on future orders issued by the presiding court that could result in the SEC recognizing a receivable at a later date. The SEC's policy is to record a receivable in those cases at the point in time when the debtor is required, as a result of a court order or other legally binding instrument, to remit funds to SEC.

Beginning June 30, 2006, the SEC implemented a new accounting method governing the write-off of debts that are two or more years old, as discussed in *Note 1. E. Change in Accounting Method.*

For FY 2006, the allowance for uncollectible amounts and the related provision for estimated losses for disgorgement and penalties and FOIA accounts receivable is based on an analysis of the collectibility of individual account balances for the largest debts and on historical collection data to determine on a percentage basis the value of gross accounts receivable that are likely to be collected by the SEC. This percentage is applied to the remaining disgorgement and penalties and FOIA accounts receivable to reflect the balances at their estimated net realizable value. The allowance for uncollectible amounts and the related provision for estimated losses for Filing Fees and other accounts receivable is based on historical collection data to determine on a percentage basis the value of gross accounts receivable that are likely to be collected by the SEC; and no allowance for uncollectible amounts and the related provision for estimated losses has been established for Due for Reimbursable Agreements and Exchange Fees, as these gross accounts receivable are deemed to represent their net realizable value. In addition, the SEC does not recognize interest as accounts receivable, unless a court or administrative order specifies the amount of pre- and post-judgment interest.

The SEC's policy on the allowance for uncollectible amounts and the related provision for estimated losses is the same for FY 2005, except the SEC has reserved 100 percent of the disgorgement and penalties and FOIA accounts receivable amounts that are two or more years old rather than removing these debts and corresponding allowance balances in accordance with the new write-off method in effect for FY 2006.

N. Advances and Prepayments

The SEC may advance funds to its personnel for travel costs, and these amounts are expensed when the travel takes place. The SEC may also prepay amounts in anticipation of receiving future benefits. These payments are expensed when the goods have been received or services have been performed.

O. Cash

The SEC's cash balance consists of petty cash funds maintained to reimburse personnel for minor expenses.

P. Property and Equipment

The SEC's property and equipment consist of software and general purpose equipment used by the agency; capital improvements made to buildings leased by the SEC for office space; and internal-use software development costs for projects in development. Property and equipment purchases and additions are stated at cost. Property and equipment acquisitions that do not meet the capitalization criteria, normal repairs, and maintenance are charged to expense as received or incurred by the SEC.

Property and equipment are depreciated over their estimated useful lives using the straight-line method of depreciation. Contractor costs for developing custom internal use software are capitalized when incurred for the design, coding, and testing of the software. Software in progress is not amortized until placed in service. The table on the following page summarizes the major classes of depreciable property and the SEC's capitalization policies.

CLASS OF PROPERTY AND EQUIPMENT	CAPITALIZATION THRESHOLD FOR INDIVIDUAL PURCHASES	CAPITALIZATION THRESHOLD FOR BULK PURCHASES
Equipment	$15 thousand or greater	$500 thousand or greater
Furniture	$15 thousand or greater	$50 thousand or greater
Software	$300 thousand or greater	$300 thousand or greater
Software in Progress	$300 thousand or greater	Not applicable
Leasehold Improvements	$300 thousand or greater	Not applicable

All classes of property and equipment, except software in progress, are removed from the SEC's asset accounts in the period of disposal, retirement, or removal from service. Any difference between the book value of the property and equipment and amounts realized is recognized as a gain or loss in the same period that the asset is removed. Software in progress is expensed when the project is abandoned because the SEC has determined that the project will no longer provide value to the agency.

Q. Liabilities

The SEC records liabilities for amounts that are likely to be paid as the result of events that have occurred as of September 30, 2006 and 2005. The SEC's liabilities consist of routine operating accounts payable, accrued payroll and benefits, registrant deposit accounts, and fiduciary and custodial liabilities associated with monetary sanctions imposed on violators of securities laws.

Fiduciary and custodial liabilities represent the largest portion of the SEC's liabilities. Custodial liabilities arise in respect of accounts receivable for disgorgement, penalties, and interest assessed against securities law violators. The SEC records a custodial liability for the net amount of such receivables, after taking into account the estimated allowance for doubtful accounts. When the SEC collects this revenue, it is either transferred to the Treasury or it is held by the SEC in a fiduciary capacity on behalf of harmed investors to whom the SEC intends to return the funds. Fiduciary liabilities arise when the SEC collects disgorgement, penalties, and interest from securities law violators which will be returned to harmed investors. When collected, fiduciary receipts are held in Fund Balance with Treasury or invested in Treasury securities pending distribution to harmed investors, and an equal and offsetting fiduciary liability for assets held by the SEC at the Treasury is reported as a non-entity liability on the balance sheet.

The SEC considers liabilities covered by three types of resources: realized budgetary resources; unrealized budgetary resources that become available without further Congressional action; and cash and amounts held in Fund Balance With Treasury that do not require the use of a budgetary resource. Realized budgetary resources include obligated balances that fund existing liabilities and unobligated balances at September 30, 2006 and 2005. Unrealized budgetary resources represent fee collections in excess of amounts appropriated for current fiscal year spending. These resources are used to cover liabilities when appropriation language makes these unrealized budgetary resources available in the fiscal year without further Congressional action.

Fund Balance With Treasury and cash include amounts for liabilities that will never require the use of a budgetary resource. These liabilities consist of registrant deposit accounts; accounts receivable for disgorgement, penalties, and interest assessed against securities laws violators, and uninvested fiduciary assets held by the SEC on behalf of harmed investors.

R. Injury and Post-Employment Compensation

Claims brought by SEC employees for on-the-job injuries fall under the Federal Employees' Compensation Act (FECA) administered by the United States

Department of Labor (DOL). The DOL bills each agency annually as its claims are paid, but payment on these bills is deferred for two years to allow for funding through the budget process. Similarly, SEC employees who are terminated without cause may receive unemployment compensation benefits under the unemployment insurance program also administered by the DOL, which bills each agency quarterly for paid claims.

S. Annual, Sick, and Other Leave

Annual leave and compensatory time are accrued as earned and the accrual is reduced when leave is taken. Each fiscal quarter an adjustment is made so that the balances in the accrued leave accounts reflect current leave balances and pay rates. No portion of this liability has been obligated. Funding will be obtained from future financing sources to the extent current or prior year funding is not available to pay for leave earned but not taken. Sick leave and other types of non-vested leave are expensed as used.

T. Employee Retirement Systems and Benefits

SEC employees participate in either the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS), depending on when they were hired by the federal government. The FERS was established by enactment of Public Law 99-335. Pursuant to this law, the FERS and Social Security automatically cover most employees hired after December 31, 1983. Employees who are rehired after a break in service of more than one year and who had five years of federal civilian service prior to 1987 are placed in the CSRS offset retirement system or may elect to join the FERS.

The SEC's financial statements do not report CSRS or FERS assets or accumulated plan benefits that may be applicable to its employees. The reporting of such liabilities is the responsibility of the United States Office of Personnel Management (OPM). While the SEC reports no liability for future payments to employees under these programs, the federal government is liable for future payments to employees through the various agencies administering these programs. The SEC does not fund post-retirement benefits such as the Federal Employees Health Benefit Program (FEHB) and the Federal Employees Group Life Insurance Program (FEGLI). The SEC is also not required to fully fund the CSRS pension liabilities.

Instead, the financial statements of the SEC recognize an imputed financing source and corresponding expense that represent the SEC's share of the cost to the federal government of providing pension, post-retirement health, and life insurance benefits to all eligible SEC employees. For the fiscal year ended September 30, 2006, the SEC made contributions based on OPM cost factors equivalent to approximately 6.78 percent and 10.91 percent of the employee's basic pay for those employees covered by CSRS and FERS, respectively. For the fiscal year ended September 30, 2005, the SEC made contributions based on OPM cost factors equivalent to approximately 6.79 percent and 10.85 percent of the employee's basic pay for those employees covered by CSRS and FERS, respectively. All employees are eligible to contribute to a thrift savings plan. For those employees participating in the FERS, a thrift savings plan is automatically established, and the SEC makes a mandatory 1 percent contribution to this plan. In addition, the SEC makes matching contributions ranging from 1 to 4 percent for FERS-eligible employees who contribute to their thrift savings plans. FERS participating employees are also covered under the Federal Insurance Contributions Act (FICA), for which the SEC contributes a matching amount to the Social Security Administration. No matching contributions are made to the thrift savings plans for employees participating in the CSRS.

U. Environmental Cleanup

The SEC does not have any liabilities for environmental cleanup.

V. Custodial Activities

The Statement of Custodial Activity presents the sources and disposition of SEC custodial activity that consists of primarily disgorgement, penalties, and interest assessed against violators of securities laws. When collected, the funds are either returned to the Treasury or the funds are held for future distribution to harmed investors, as discussed in *Note 1. M. Accounts Receivable and Allowance for Uncollectible Accounts.*

W. Fiduciary Activities

Fiduciary activities represent the receipt, management, accounting, and disposition by the SEC of cash or other assets in which harmed investors have an ownership interest that the SEC must uphold. The SEC also recognizes an equal and offsetting liability for these assets.

The SEC's fiduciary assets consist of disgorgement, penalties, and interest assessed against securities laws violators where the Commission, an administrative law judge, or, in some cases, a court has determined that the SEC should return such funds to harmed investors. The funds are held as fiduciary assets by the SEC pending distribution to harmed investors pursuant to an approved distribution plan. The SEC does not record fiduciary asset amounts collected and held by another government entity, such as a court, or a non-government entity, such as a receiver.

Note 2. Fund Balance With Treasury

At September 30, 2006, Fund Balance With Treasury consisted of the following:

(DOLLARS IN THOUSANDS)	UNRESTRICTED FUNDS	RESTRICTED FUNDS	TOTAL
Funds Obligated But Not Disbursed	$229,971	$ —	$ 229,971
Funds Not Obligated	123,942	4,752,856	4,876,798
Subtotal Entity Funds	353,913	4,752,856	5,106,769
Registrant Deposits	57,464	—	57,464
Uninvested Fiduciary Assets	5,759	—	5,759
Securities Transaction Fee Refund	8,901	—	8,901
Subtotal Non-Entity Funds	72,124	—	72,124
Total Fund Balance With Treasury	$426,037	$4,752,856	$5,178,893

At September 30, 2005, Fund Balance With Treasury consisted of the following:

(DOLLARS IN THOUSANDS)	UNRESTRICTED FUNDS	RESTRICTED FUNDS	TOTAL
Funds Obligated But Not Disbursed	$235,499	$ —	$ 235,499
Funds Not Obligated	136,299	3,703,675	3,839,974
Subtotal Entity Funds	371,798	3,703,675	4,075,473
Registrant Deposits	65,934	—	65,934
Uninvested Fiduciary Assets	207,529	—	207,529
Subtotal Non-Entity Funds	273,463	—	273,463
Total Fund Balance With Treasury	$645,261	$3,703,675	$4,348,936

Registrant deposit accounts are for filers who maintain a deposit account at the SEC to facilitate the filing process. These funds are drawn down when filers submit filings, and filers can replenish their deposit account as desired. Account balances with no activity for six months are returned to the registrant. Funds maintained in registrant deposit accounts are not available for SEC use until a filing has been submitted to the SEC, and then the funds are reclassified to entity funds.

Note 3. Non-Entity Assets

At September 30, 2006 and 2005, non-entity assets consisted of the following:

(DOLLARS IN THOUSANDS)	FY 2006	FY 2005
Registrant Deposits (Fund Balance With Treasury)	$ 57,464	$ 65,934
Fiduciary Assets (Fund Balance With Treasury, Investments, and Accounts Receivable)	3,834,662	1,975,553
Custodial Assets (Accounts Receivable)	71,545	95,512
Securities Transaction Fee Refund (Fund Balance With Treasury)	8,901	—
Total Non-Entity Assets	$3,972,572	$2,136,999

Note 4. Cash

At September 30, 2005, cash and other monetary assets represented a petty cash balance of $9 thousand. These petty cash funds were closed during FY 2006.

Note 5. Investments

At September 30, 2006, investments consisted of Treasury Special Overnight Certificates of Indebtedness and Market-Based Treasury Bills, summarized as follows:

(DOLLARS IN THOUSANDS)

COST	AMORTIZATION METHOD	INTEREST EARNED	OTHER ADJUSTMENTS	INVESTMENTS, NET
$3,610,550	S/L	$130,385	$(66,407)	$3,674,528

At September 30, 2005, investments consisted of Treasury Special Overnight Certificates of Indebtedness and Market-Based Treasury Bills, summarized as follows:

(DOLLARS IN THOUSANDS)

COST	AMORTIZATION METHOD	INTEREST EARNED	OTHER ADJUSTMENTS	INVESTMENTS, NET
$1,746,228	S/L	$30,483	$(8,687)	$1,768,024

As discussed in *Note 1. L. Investments* and *Note 19. Fiduciary Assets and Liabilities,* the investments represent disgorgement, penalties, and interest collected from securities law violators on behalf of harmed investors. Invested funds are held by the SEC pending distribution to harmed investors. The SEC invests these funds in overnight and short-term market-based Treasury bills through a facility provided by the BPD. The market value for these investments is the same as the net value stated above. Other adjustments are disbursements for estimated income tax payments because these funds are qualified settlement funds under Section 1.468B of the Internal Revenue Code and fees charged by the BPD. Unamortized discount on investments at September 30, 2006 and 2005 were $28.0 million and $0.8 million, respectively.

Note 6. Accounts Receivable, Net

At September 30, 2006, accounts receivable consisted of the following:

(DOLLARS IN THOUSANDS)	GROSS RECEIVABLES	ALLOWANCE	NET RECEIVABLES
Entity Intragovernmental Assets:			
Due for Reimbursable Agreements	$ 131	$ —	$ 131
Non-Entity Intragovernmental Assets:			
Disgorgement and Penalties	154,375	—	154,375
Subtotal Intragovernmental Assets	154,506	—	154,506
Entity Assets:			
Exchange Fees	105,416	—	105,416
Filing Fees	232	5	227
Other	305	2	303
Non-Entity Assets:			
Disgorgement and Penalties	247,631	176,086	71,545
Subtotal Non-Intragovernmental Assets	353,584	176,093	177,491
Total	$ 508,090	$ 176,093	$331,997

At September 30, 2005, accounts receivable consisted of the following:

(DOLLARS IN THOUSANDS)	GROSS RECEIVABLES	ALLOWANCE	NET RECEIVABLES
Entity Intragovernmental Assets:			
Due for Reimbursable Agreements	$ 194	$ —	$ 194
Subtotal Intragovernmental Assets	194	—	194
Entity Assets:			
Exchange Fees	126,589	—	126,589
Filing Fees	26	—	26
Other	281	7	274
Non-Entity Assets:			
Disgorgement and Penalties	1,364,610	1,269,099	95,511
FOIA Fees	1	—	1
Subtotal Non-Intragovernmental Assets	1,491,507	1,269,106	222,401
Total	$1,491,701	$1,269,106	$222,595

Note 7. Property and Equipment, Net

At September 30, 2006, property and equipment consisted of the following:

CLASS OF PROPERTY *(DOLLARS IN THOUSANDS)*	DEPRECIATION/ AMORTIZATION METHOD	SERVICE LIFE (YEARS)	ACQUISITION VALUE	ACCUMULATED DEPRECIATION/ AMORTIZATION	BOOK VALUE
Furniture	S/L	5	$ 8,569	$ 2,165	$ 6,404
Equipment	S/L	3	37,155	25,788	11,367
Software	S/L	3-5	48,711	36,032	12,679
Software in Progress	N/A	N/A	10,117	—	10,117
Leasehold Improvements	S/L	10	69,104	6,040	63,064
Total			$173,656	$70,025	$103,631

At September 30, 2005, property and equipment consisted of the following:

CLASS OF PROPERTY *(DOLLARS IN THOUSANDS)*	DEPRECIATION/ AMORTIZATION METHOD	SERVICE LIFE (YEARS)	ACQUISITION VALUE	ACCUMULATED DEPRECIATION/ AMORTIZATION	BOOK VALUE
Furniture	S/L	5	$ 5,295	$ 508	$ 4,787
Equipment	S/L	3	36,392	17,565	18,827
Software	S/L	3-5	38,524	28,691	9,833
Software in Progress	N/A	N/A	7,350	—	7,350
Leasehold Improvements	S/L	10	33,447	935	32,512
Total			$121,008	$47,699	$ 73,309

Leasehold improvements include costs incurred for new locations in Washington, D.C., Boston, and New York. The SEC occupied the first of its new headquarters buildings during FY 2005 and the second building in FY 2006. Therefore, no amortization expense was recognized in FY 2005 for the leasehold improvements to the second building. During FY 2006, the SEC also occupied new office space in Boston and New York, and began amortizing the leasehold improvements for those office locations.

Note 8. Liabilities

At September 30, 2006 and 2005, liabilities consisted of the following:

(DOLLARS IN THOUSANDS)	FY 2006	FY 2005
Liabilities Covered by Budgetary Resources		
Intragovernmental		
Accounts Payable	$ 14,527	$ 16,848
Employee Benefits	2,687	2,702
Total Intragovernmental Liabilities	17,214	19,550
Accounts Payable	47,608	28,014
Accrued Payroll and Benefits	18,149	18,436
Registrant Deposits	57,464	65,934
Custodial Liability	71,545	95,512
Fiduciary Liability	3,834,662	1,975,553
Other Accrued Liabilities—Commitments and Contingencies	—	700
Other Accrued Liabilities—Employee Awards	2,036	4,225
Other Accrued Liabilities—Student Loans	3,902	2,098
Other Accrued Liabilities—Securities Transaction Fee Refund	8,901	—
Total Liabilities Covered by Budgetary Resources	4,061,481	2,210,022
Liabilities Not Covered by Budgetary Resources		
Intragovernmental		
Unfunded FECA Liability	992	1,045
Total Intragovernmental Liabilities	992	1,045
Other Accrued Liabilities—Recognition of Lease Liability	27,641	21,647
Accrued Leave	32,974	32,024
Actuarial FECA Liability	4,813	5,475
Total Liabilities Not Covered by Budgetary Resources	66,420	60,191
Total Liabilities	$4,127,901	$2,270,213

Note 9. Actuarial FECA Liability

The FECA provides income and medical cost protection to covered federal civilian employees harmed on the job and for those who have contracted a work-related occupational disease, and dependents of employees whose death is attributable to a job-related injury or occupational disease. Claims incurred for benefits under the FECA for the SEC's employees are administered by the DOL and, ultimately, are paid by the SEC.

The SEC's estimate is based on the DOL's model for estimating the FECA actuarial liability for federal agencies not specified in the DOL's FECA model. The model considers the average amount of benefit payments incurred by the SEC for the past three fiscal years, multiplied by the medical and compensation liability to benefits paid (LBP) ratio for the whole FECA program, estimated at approximately 11 times the annual payments. To capture variability, the model estimates the liability using three sets of LBP ratios, summarized as follows:

For FY 2006, the LBP ratios were as follows:

LBP CATEGORY	MEDICAL	COMPENSATION
Highest	9.70%	12.80%
Overall Average	8.00%	11.90%
Lowest	7.10%	11.40%

For FY 2005, the LBP ratios were as follows:

LBP CATEGORY	MEDICAL	COMPENSATION
Highest	9.10%	13.40%
Overall Average	8.00%	12.30%
Lowest	7.00%	11.40%

For FY 2006 and 2005, the SEC used the Overall Average LBP ratios to calculate the $4.8 million and $5.5 million FECA actuarial liabilities for those years, respectively.

Note 10. Leases

The SEC has the authority to negotiate long-term leases for office space. At September 30, 2006, the SEC leased office space at 18 locations under operating lease agreements that expire between 2008 and 2021. The SEC paid $80,958 thousand and $66,538 thousand for rent for FY 2006 and 2005, respectively. Under existing commitments, the minimum lease payments through FY 2011 and thereafter are as follows:

FISCAL YEAR *(DOLLARS IN THOUSANDS)*	MINIMUM LEASE PAYMENTS
2007	$ 82,292
2008	78,958
2009	76,952
2010	75,260
2011	75,266
2012 and thereafter	470,671
Total Future Minimum Lease Payments	$859,399

The total future minimum lease payments summarized above include a liability the SEC has recognized for office space leased in Washington, D.C. and New York. During FY 2006, the SEC moved into new office space and vacated old office space in Washington, D.C. While the SEC is marketing the old office space for potential tenants, the SEC is responsible for the remaining $7,448 thousand of lease payments that end in FY 2008.

During FY 2005, the SEC also entered into a lease agreement for new office space in New York. With respect to its prior New York office space, the SEC and U.S. General Services Administration (GSA) entered into separate agreements with the lessor. The GSA has agreed to rent the office space from the lessor for the next five years of the SEC's lease. At that time, the GSA has the option to renew the agreement for the remaining 15 months of the SEC's lease. As part of the SEC's agreement with the lessor, the SEC was responsible for the estimated $18 million difference between its annual lease liability and the annual lease liability negotiated by the GSA with the lessor.

FISCAL YEAR (DOLLARS IN THOUSANDS)	REQUIRED LEASE PAYMENTS NEW YORK	WASHINGTON, D.C.	TOTAL
2007	$ 2,603	$5,586	$ 8,189
2008	2,722	1,862	4,584
2009	2,722	—	2,722
2010	2,722	—	2,722
2011	2,469	—	2,469
2012	1,192	—	1,192
Total Future Estimated Lease Payments	$14,430	$7,448	$21,878

In addition, during FY 2005, the SEC moved into temporary office space in New York because the new office space was under renovation. This temporary office space was being provided to the SEC for only the lessor's operating costs, and therefore, the SEC did not pay rent expense for its New York office for five months of the fiscal year. The SEC has attributed rent expense on a straight-line basis over the life of its new lease, and recorded rent expense estimated at $3.6 million in FY 2005. In FY 2006, the SEC recorded an additional six months of rent expense totaling approximately $4.4 million and recorded a reduction to the liability for 6 months totaling $0.3 million. For FY 2006 and 2005, the SEC recognized an unfunded liability of $27.6 million and $21.6 million, respectively to cover the three lease obligations (See *Note 8. Liabilities).*

Note 11. Imputed Financing

The SEC recognizes an imputed financing source and corresponding expense to represent its share of the cost to the federal government of providing pension and post-retirement health and life insurance benefits (Pension/Other Retirements Benefits (ORB)) to all eligible SEC employees. For FY 2006 and 2005, the components of the imputed financing sources and corresponding expenses were as follows:

PENSION/ORB CATEGORY *(DOLLARS IN THOUSANDS)*	FY 2006	FY 2005
CSRS	$ 6,956	$ 6,999
FERS	1,269	1,416
FEHB	18,525	17,320
FEGLI	93	88
Other	7	9
Total Pension/ORB	$26,850	$25,832

Note 12. Intragovernmental Costs and Exchange Revenue

Program costs are accumulated by responsibility segment and consist of costs related directly to the individual program lines and overall support costs allocated to the program lines. All costs incurred during FY 2006 and 2005 were assigned to specific program lines, but exchange revenue is not directly assignable to a specific program, and is presented in total. For FY 2006 and 2005, total intragovernmental and public program operating costs are summarized below.

PROGRAM COSTS *(DOLLARS IN THOUSANDS)*	FY 2006	FY 2005
Compliance Inspections and Exams		
Intragovernmental Costs	$ 39,667	$ 46,367
Public Costs	201,530	202,605
Subtotal—Compliance Inspections and Exams	241,197	248,972
Corporation Finance		
Intragovernmental Costs	21,049	24,772
Public Costs	104,434	102,859
Subtotal—Corporation Finance	125,483	127,631
Enforcement		
Intragovernmental Costs	56,990	72,502
Public Costs	279,736	292,013
Subtotal—Enforcement	336,726	364,515
Investment Management		
Intragovernmental Costs	7,216	9,438
Public Costs	43,296	39,970
Subtotal—Investment Management	50,512	49,408
Market Regulation		
Intragovernmental Costs	7,588	8,739
Public Costs	39,301	37,745
Subtotal—Market Regulation	46,889	46,484
Other Offices		
Intragovernmental Costs	13,554	15,028
Public Costs	74,562	65,612
Subtotal—Other Offices	88,116	80,640
Total Entity		
Intragovernmental Costs	146,064	176,846
Public Costs	742,859	740,804
Total Costs	888,923	917,650
Less Exchange Revenues	(1,882,619)	(1,745,111)
Net (Income) from Operations	$ (993,696)	$ (827,461)

Note 13. Program Costs by Category

For FY 2006, program costs by cost category were as follows:

COST CATEGORY (DOLLARS IN THOUSANDS)	COMPLIANCE INSPECTIONS AND EXAMS	CORPORATION FINANCE	ENFORCEMENT	INVESTMENT MANAGEMENT	MARKET REGULATION	OTHER OFFICES	TOTAL
Direct Costs							
Personnel Services and Benefits	$130,372	$ 73,027	$ 187,647	$26,507	$26,881	$48,185	$ 492,619
Compensation and Benefits	5,997	3,278	7,304	1,311	1,345	2,322	21,557
Travel and Transportation	384	143	1,601	44	512	782	3,466
Rent, Communications, and Utilities	53	7	4	—	—	20	84
Printing and Reproduction	—	—	905	—	—	2	907
Contractual Services	—	238	8,423	—	(9)	702	9,354
Supplies and Materials	—	—	—	—	—	—	—
Depreciation and Amortization	15	25	79	13	191	387	710
Loss on Asset Disposition	1	—	—	1	3	1	6
Subtotal Direct Costs	136,822	76,718	205,963	27,876	28,923	52,401	528,703
Allocated Costs							
Personnel Services and Benefits	23,590	9,583	30,773	3,414	3,544	6,387	77,291
Compensation and Benefits	1,859	805	2,453	289	298	538	6,242
Unfunded Estimated FECA Expense	(69)	(36)	(91)	(12)	(13)	(23)	(244)
Travel and Transportation	2,412	94	2,542	34	35	106	5,223
Rent, Communications, and Utilities	28,710	13,676	31,262	10,603	5,028	12,813	102,092
Printing and Reproduction	1,319	674	1,729	223	248	430	4,623
Contractual Services	20,518	9,873	27,288	3,374	3,638	6,465	71,156
Abandonment of Software in Development Project	—	—	—	—	—	—	—
Training	1,143	600	1,512	200	221	384	4,060
Maintenance and Repairs	468	153	569	51	56	100	1,397
Supplies and Materials	1,080	302	1,284	105	111	207	3,089
Equipment Not Capitalized	3,182	1,572	4,191	536	579	1,024	11,084
Insurance Claims and Indemnities	97	51	128	17	19	32	344
Depreciation and Amortization	6,431	4,295	9,104	1,436	1,583	2,706	25,555
Loss on Asset Disposition	304	152	406	50	56	97	1,065
Land and Structures	13,330	6,971	17,612	2,316	2,563	4,449	47,241
Other	1	—	1	—	—	—	2
Subtotal Allocated Costs	104,375	48,765	130,763	22,636	17,966	35,715	360,220
Total Program Costs	$ 241,197	$125,483	$336,726	$ 50,512	$46,889	$ 88,116	$888,923

For FY 2005, program costs by cost category were as follows:

COST CATEGORY (DOLLARS IN THOUSANDS)	COMPLIANCE INSPECTIONS AND EXAMS	CORPORATION FINANCE	ENFORCEMENT	INVESTMENT MANAGEMENT	MARKET REGULATION	OTHER OFFICES	TOTAL
Direct Costs							
Personnel Services and Benefits	$124,020	$ 73,097	$187,003	$29,547	$ 26,159	$45,599	$485,425
Compensation and Benefits	6,615	3,673	8,277	1,285	1,264	2,531	23,645
Travel and Transportation	810	144	1,698	131	634	955	4,372
Rent, Communications, and Utilities	29	4	—	—	—	12	45
Printing and Reproduction	—	—	3,210	—	—	—	3,210
Contractual Services	—	230	12,869	—	39	974	14,112
Supplies and Materials	—	—	—	—	—	—	—
Depreciation and Amortization	—	12	812	566	154	290	1,834
Loss on Asset Disposition	—	1	1	1	—	1	4
Subtotal Direct Costs	131,474	77,161	213,870	31,530	28,250	50,362	532,647
Allocated Costs							
Personnel Services and Benefits	23,353	9,186	30,870	3,463	3,326	5,675	75,873
Compensation and Benefits	1,705	678	2,201	256	245	420	5,505
Unfunded Estimated FECA Expense	227	119	300	44	43	72	805
Travel and Transportation	3,152	126	3,395	47	46	110	6,876
Rent, Communications, and Utilities	34,381	13,337	40,774	4,329	4,813	7,644	105,278
Printing and Reproduction	4,816	2,516	6,390	936	908	1,526	17,092
Contractual Services	22,183	9,875	29,301	3,692	3,569	6,120	74,740
Abandonment of Software in Development Project	47	24	68	9	9	15	172
Training	467	245	620	91	89	148	1,660
Maintenance and Repairs	429	132	515	49	47	81	1,253
Supplies and Materials	984	326	1,233	122	118	204	2,987
Equipment Not Capitalized	21,735	11,015	28,703	4,096	3,976	6,703	76,228
Insurance Claims and Indemnities	188	99	250	37	36	60	670
Depreciation and Amortization	3,795	2,775	5,976	701	1,003	1,490	15,740
Loss on Asset Disposition	36	17	49	6	6	10	124
Land and Structures	—	—	—	—	—	—	—
Other	—	—	—	—	—	—	—
Subtotal Allocated Costs	117,498	50,470	150,645	17,878	18,234	30,278	385,003
Total Program Costs	$248,972	$127,631	$364,515	$49,408	$46,484	$80,640	$ 917,650

Note 14. Exchange Revenues

For FY 2006 and 2005, exchange revenues consisted of the following:

(DOLLARS IN THOUSANDS)	FY 2006	FY 2005
Securities Transactions Fees	$1,382,805	$1,150,184
Securities Registration, Tender Offer, and Merger Fees	499,236	594,685
Other	578	242
Total Exchange Revenues	$1,882,619	$1,745,111

Note 15. Transfers Without Reimbursement

For FY 2006, transfers of budgetary authority (from) to other SEC funds consisted of the following:

	INTRA-AGENCY TRANSFERS		
(DOLLARS IN THOUSANDS)	INDEFINITE AUTHORITY	GENERAL FUND	NET TRANSFERS
To Transfer Canceling Authority	$7,877	$(7,877)	$ —
Net Transfers	$7,877	$(7,877)	$ —

For FY 2005, transfers of budgetary authority (from) to other SEC funds consisted of the following:

	INTRA-AGENCY TRANSFERS		
(DOLLARS IN THOUSANDS)	INDEFINITE AUTHORITY	GENERAL FUND	NET TRANSFERS
To Fund Current Year Operations	$57,000	$(57,000)	$ —
To Transfer Canceling Authority	5,232	(5,232)	—
Net Transfers	$62,232	$(62,232)	$ —

Intra-agency transfers represent funding from prior years unobligated balances to fund the current year appropriation level or to transfer canceling unobligated balances to indefinite authority.

Note 16. Status of Budgetary Resources

A. Apportionment Categories of Obligations Incurred

For FY 2006 and 2005, obligations incurred as reported on the Statement of Budgetary Resources consisted of the following:

OBLIGATIONS INCURRED *(DOLLARS IN THOUSANDS)*	FY 2006	FY 2005
Direct Obligations		
Category A	$896,911	$960,753
Total Direct Obligations	896,911	960,753
Reimbursable Obligations		
Category B	519	580
Total Reimbursable Obligations	519	580
Total Obligations Incurred	$897,430	$961,333

The amounts of budgetary resources obligated for undelivered orders were $140,595 thousand and $162,080 thousand as of September 30, 2006 and 2005, respectively.

B. Explanation of Differences between the Statement of Budgetary Resources and the Budget of the United States Government

The distinction between Category A and B funds is that Category A funds are subject to quarterly apportionment by the OMB, while Category B funds are available for use by the agency without being subject to apportionment. For FY 2005, there were no material differences between the Statement of Budgetary Resources and the Budget of the United States Government. In addition, a comparison between the Statements of Budgetary Resources and the actual FY 2006 data in the President's Budget cannot be performed as the FY 2008 President's Budget is not yet available.

Note 17. Components Requiring or Generating Resources in Future Periods

The relationship between the amounts reported as liabilities not covered by budgetary resources on the Balance Sheets, as shown in *Note 8. Liabilities,* and the amounts reported as components requiring or generating resources in future periods on the Statements of Financing was analyzed. The changes in accrued leave, lease liability, and unfunded FECA liability are reported in the Statements of Financing.

These changes represent the increases/decreases in liabilities not covered by budgetary resources. The other liabilities on the Balance Sheets are covered by the budgetary resources, therefore, are not part of the Statements of Financing.

(DOLLARS IN THOUSANDS)	FY 2006	FY 2005
Current Year Liabilities Not Covered By Budgetary Resources	$66,420	$ 60,191
Prior Year Liabilities That Are Not Components of Current Year Net Cost	(60,191)	(34,967)
Increase/Decrease in Accrued Leave, Lease Liability, and Unfunded FECA Liability, As Reported on the Statements of Financing	$ 6,229	$ 25,224

Note 18. Custodial Revenues and Liabilities

For FY 2006, custodial revenues consisted of the following:

(DOLLARS IN THOUSANDS)	DISGORGEMENT AND PENALTIES	OTHER	TOTAL
Cash Collections	$ 1,804,043	$ 90	$ 1,804,133
Less: Refunds	—	—	—
Net Cash Collections	1,804,043	90	1,804,133
Increase/(Decrease) in Amounts to be Collected	(23,967)	—	(23,967)
Total Non-Exchange Revenues	$ 1,780,076	$ 90	$ 1,780,166

At September 30, 2006, custodial liabilities consisted of the following:

(DOLLARS IN THOUSANDS)	DISGORGEMENT AND PENALTIES	OTHER	TOTAL
Gross Custodial Accounts Receivable	$ 247,631	$ —	$ 247,631
Less: Allowance for Doubtful Accounts	(176,086)	—	(176,086)
Net Custodial Liability	$ 71,545	$ —	$ 71,545

For FY 2005, custodial revenues consisted of the following:

(DOLLARS IN THOUSANDS)	DISGORGEMENT AND PENALTIES	OTHER	TOTAL
Cash Collections	$ 1,606,274	$270	$ 1,606,544
Less: Refunds	—	—	—
Net Cash Collections	1,606,274	270	1,606,544
Increase/(Decrease) in Amounts to be Collected	(183,535)	(7)	(183,542)
Total Non-Exchange Revenues	$ 1,422,739	$263	$ 1,423,002

At September 30, 2005, custodial liabilities consisted of the following:

(DOLLARS IN THOUSANDS)	DISGORGEMENT AND PENALTIES	OTHER	TOTAL
Gross Custodial Accounts Receivable	$ 1,364,610	$ 1	$ 1,364,611
Less: Allowance for Doubtful Accounts	(1,269,099)	—	(1,269,099)
Net Custodial Liability	$ 95,511	$ 1	$ 95,512

Note 19. Fiduciary Assets and Liabilities

At September 30, 2006 and 2005, the assets held by the SEC in a fiduciary capacity and its offsetting liability consisted of the following:

FIDUCIARY ACTIVITIES *(DOLLARS IN THOUSANDS)*	FY 2006	FY 2005
Assets		
Fund Balance With Treasury	$ 5,759	$ 207,529
Investments	3,674,528	1,768,024
Accounts Receivable	154,375	—
Total Assets	$3,834,662	$1,975,553
Liabilities		
Liability for Fiduciary Activity	$3,834,662	$1,975,553
Total Liabilities	$3,834,662	$1,975,553

For FY 2006 and 2005, the source and disposition of the SEC's fiduciary activities consisted of the following:

FIDUCIARY ACTIVITIES *(DOLLARS IN THOUSANDS)*	FY 2006	FY 2005
Fund Balance With Treasury		
Beginning Balance	$ 207,529	$ 863,167
Disgorgement and Penalties	1,639,914	1,112,386
Transfer to Investments	(1,841,684)	(1,768,024)
Total Fund Balance With Treasury	5,759	207,529
Investments		
Beginning Balance	1,768,024	—
Net Investments Activity—Disgorgement and Penalties	1,906,504	1,768,024
Total Investments	3,674,528	1,768,024
Accounts Receivable		
Beginning Balance	—	—
Net Activity-Accounts Receivable	154,375	—
Total Accounts Receivable	154,375	—
Total Assets	$3,834,662	$1,975,553
Liability for Fiduciary Activity		
Beginning Balance	$ 1,975,553	$ 863,167
Disgorgement and Penalties	1,859,109	1,112,386
Total Liabilities	$3,834,662	$1,975,553

Note 20. Commitments and Contingencies

A. Commitments

The Securities Investor Protection Act of 1970, as amended (SIPA) created the SIPC to provide certain financial protections to customers of insolvent registered securities brokers, dealers, firms, and members of national securities exchanges for up to $500,000 per customer. The SIPA authorizes the SIPC to create a fund to maintain all moneys received and disbursed by the SIPC. The SIPA also gives the SIPC the authority to borrow funds from the SEC in an amount not to exceed in the aggregate $1 billion in the event that the SIPC fund is or may appear insufficient for purposes of the SIPA. If necessary, these funds would be made available to the SEC through the purchase by the Treasury of notes or other obligating instruments issued by the SEC. Such notes or other obligating instruments would bear interest at a rate determined by the Secretary of the Treasury. As of September 30, 2006 and 2005, the SEC had not loaned any funds to the SIPC, and there are no outstanding notes or other obligating instruments issued by the SEC.

In addition to the future lease commitments discussed in *Note 10. Leases,* the SEC is obligated for the purchase of goods and services that have been ordered, but not yet received. For FY 2006, net obligations for all of the SEC's activities were $229,308 thousand and of this amount $89,507 thousand were delivered and unpaid. For FY 2005, net obligations for all of the SEC's activities were $235,508 thousand and of this amount $73,622 thousand were delivered and unpaid.

B. Contingencies

The SEC is party to various routine administrative proceedings, legal actions, and claims brought by or against it, including threatened or pending litigation involving labor relations claims, some of which may ultimately result in settlements or decisions against the federal government. As of September 30, 2006, SEC management does not expect to owe for claims. As of September 30, 2005, SEC management expected that approximately $700 thousand was owed for Equal Access to Justice matters.

GAO
Accountability ★ Integrity ★ Reliability

Comptroller General
of the United States

United States Government Accountability Office
Washington, D.C. 20548

To the Chairman of the United States Securities and Exchange Commission

In our audits of the United States Securities and Exchange Commission (SEC) for fiscal years 2006 and 2005, we found

- the financial statements as of and for the fiscal years ended September 30, 2006, and 2005, including the accompanying notes, are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles;
- although certain internal controls should be improved, SEC had effective internal control over financial reporting (including safeguarding assets) and compliance with laws and regulations as of September 30, 2006; and
- no reportable noncompliance with laws and regulations we tested.

The following sections discuss in more detail these conclusions as well as our conclusions on Management's Discussion and Analysis and other supplementary information. They also present information on the objectives, scope, and methodology of our audit and our discussion of SEC management's comments on a draft of this report.

Opinion on Financial Statements

SEC's balance sheets as of September 30, 2006, and 2005, and its related statements of net cost, changes in net position, budgetary resources, financing, and custodial activity, with accompanying notes for the fiscal years then ended, are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles.

Opinion on Internal Control

Although certain internal controls should be improved, SEC management maintained, in all material respects, effective internal control over financial reporting (including safeguarding assets) and compliance as of September 30, 2006, that provided reasonable assurance that misstatements, losses, or noncompliance material in relation to the financial statements would be prevented or detected on a timely basis. Our opinion is based on criteria established under 31 U.S.C. § 3512 (c), (d) commonly known as the Federal Managers' Financial Integrity Act (FMFIA) and OMB Circular A-123, revised June 21, 1995, *Management Accountability and Control.*

We identified three reportable conditions which, although not material weaknesses,[1] represent significant deficiencies in the design or operation of internal control that could adversely affect SEC's ability to meet its internal control objectives. These conditions, described in more detail later in this report, concern deficiencies in (1) SEC's reporting of disgorgements[2] and penalties,[3] (2) information system controls, and (3) property and equipment controls.

In our 2005 report,[4] we identified material weaknesses in the areas of SEC's (1) reporting of disgorgements and penalties, (2) information systems controls, and (3) financial reporting process. Based on SEC's efforts to address concerns with controls over disgorgements and penalties and with information systems, and based on improvements we found in these areas during our fiscal year 2006 audit, we have concluded that these two previously reported weaknesses are no longer material. Because many of these efforts represent compensating controls rather than permanent systemic solutions, deficiencies in the design and operation of internal control in these areas remain and could adversely affect SEC's recording and reporting of disgorgements and penalties and its information security. Therefore we considered these areas to still be reportable conditions. During our fiscal year 2006 audit, we have also concluded that SEC has taken sufficient action in the area of controls over the financial reporting process such that we no longer consider this issue to be a material weakness or reportable condition.

[1] Material weaknesses in internal control are reportable conditions in which the design or operation of the internal control does not reduce to a relatively low level the risk that errors, fraud, or noncompliance in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

[2] A disgorgement is the repayment of illegally gained profits (or avoided losses) for distribution to harmed investors whenever feasible.

[3] A penalty is a monetary payment from a violator of securities law that SEC obtains pursuant to statutory authority. A penalty is fundamentally a punitive measure, although penalties occasionally can be used to compensate harmed investors.

[4] GAO, *Financial Audit: Securities and Exchange Commission's Financial Statements for Fiscal Years 2005 and 2004*, GAO-06-239 (Washington, D.C.: Nov. 15, 2005); *Internal Control: Improvements Needed in SEC's Accounting and Financial Reporting Procedures*, GAO-06-459R (Washington, D.C.: Apr. 21, 2006); and *Information Security: Securities and Exchange Commission Needs to Continue to Improve Its Program*, GAO-06-408 (Washington, D.C.: Mar. 31, 2006).

Although the reportable conditions did not materially affect the 2006 financial statements, misstatements may nevertheless occur in unaudited financial information reported by SEC, including performance information, as a result of the internal control weaknesses.

Compliance with Laws and Regulations

Our tests for compliance with selected provisions of laws and regulations disclosed no instances of noncompliance that would be reportable under U.S. generally accepted government auditing standards or OMB audit guidance. However, the objective of our audit was not to provide an opinion on overall compliance with laws and regulations. Accordingly, we do not express such an opinion.

Consistency of Other Information

SEC's Management's Discussion and Analysis and other accompanying information contain a wide range of data, some of which are not directly related to the financial statements. We did not audit and do not express an opinion on this information. However, we compared this information for consistency with the financial statements and discussed the methods of measurement and presentation with SEC officials. Based on this limited work, we found no material inconsistencies with the financial statements or nonconformance with OMB guidance. However, because of the internal control weaknesses noted above, misstatements may occur in related performance measures.

Objectives, Scope, and Methodology

SEC management is responsible for (1) preparing the financial statements in conformity with U.S. generally accepted accounting principles; (2) establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of FMFIA are met; and (3) complying with applicable laws and regulations.

We are responsible for obtaining reasonable assurance about whether (1) the financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles; and (2) management maintained effective internal control that provides reasonable, but not absolute, assurance the following objectives are met:

- Financial reporting: Transactions are properly recorded, processed, and summarized to permit the timely and reliable preparation of financial statements in conformity with U.S. generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition.

- Compliance with applicable laws and regulations: Transactions are executed in accordance with (1) laws governing the use of budgetary authority, (2) other laws and regulations that could have a direct and material effect on the financial statements, and (3) any other laws, regulations, or governmentwide policies identified by OMB audit guidance.

We are also responsible for (1) testing compliance with selected provisions of laws and regulations that could have a direct and material effect on the financial statements and for which OMB audit guidance requires testing and (2) performing limited procedures with respect to certain other information appearing in SEC's Performance and Accountability Report. In order to fulfill these responsibilities, we

- examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- assessed the accounting principles used and significant estimates made by SEC management;
- evaluated the overall presentation of the financial statements;
- obtained an understanding of internal control related to financial reporting (including safeguarding of assets) and compliance with laws and regulations (including execution of transactions in accordance with budget authority);
- obtained an understanding of the design of internal controls related to the existence and completeness assertions relating to performance measures as reported in Management's Discussion and Analysis, and determined whether they have been placed in operation;
- tested relevant internal controls over financial reporting and compliance with applicable laws and regulations, and evaluated the design and operating effectiveness of internal control;
- considered SEC's process for evaluating and reporting on internal control and financial management systems under FMFIA; and

- tested compliance with selected provisions of the following laws and their related regulations:
  - the Securities Exchange Act of 1934, as amended;
  - the Securities Act of 1933, as amended;
  - the Antideficiency Act;
  - laws governing the pay and allowance system for SEC employees; and
  - the Prompt Payment Act.

We did not evaluate all internal controls relevant to operating objectives as broadly defined by FMFIA, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to controls over financial reporting and compliance. Because of inherent limitations in internal control, misstatements due to error or fraud, losses, or noncompliance may nevertheless occur and not be detected. We also caution that projecting our evaluation to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with controls may deteriorate.

We did not test compliance with all laws and regulations applicable to SEC. We limited our tests of compliance to those required by OMB audit guidance and other laws and regulations that had a direct and material effect on, or that we deemed applicable to, SEC's financial statements for the fiscal year ended September 30, 2006. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes.

We performed our work in accordance with U.S. generally accepted government auditing standards and OMB audit guidance.

SEC's management provided comments on a draft of this report. They are discussed and evaluated in a later section of this report and are reprinted in appendix I.

Reportable Conditions

We identified three reportable conditions which, although not material weaknesses, represent significant deficiencies in the design or operation of internal control that could adversely affect SEC's ability to meet its internal control objectives. These conditions concern deficiencies in (1) SEC's reporting of disgorgements and penalties, (2) information system controls, and (3) property and equipment controls, which are summarized below.

Additional details surrounding these reportable conditions, along with recommendations for corrective action, are being reported separately to SEC management. Less significant matters involving SEC's system of internal controls and its operations will also be reported to SEC separately.

Disgorgements and Penalties

As part of its enforcement responsibilities, SEC issues and administers judgments ordering, among other things, disgorgements, civil monetary penalties, and interest against violators of federal securities laws. These transactions involve material amounts of collections, and the recording and reporting of fiduciary and custodial liability balances on the financial statements.[5]

Our audit testing during fiscal year 2006 noted significant management oversight and efforts to address weaknesses in the internal controls over recording and reporting disgorgement and penalty information. During the year, SEC finalized policies and procedures for reporting disgorgement and penalty activity; improved reconciliations of disgorgement and penalty transactions; established an internal audit function within the Division of Enforcement; and had better and more timely coordination between the two key SEC units responsible for reporting and recording disgorgements and penalties. Of particular note was a comprehensive initiative SEC undertook during the year to review and verify all of the outstanding disgorgement and penalty debts. Through this project, SEC identified and corrected numerous errors in the database used to record and report disgorgements and penalties. These errors involved amounts due, judgment and due dates, the payees, and status of the cases. This project also identified steps needed with respect to collecting or terminating the

[5]Fiduciary activities represent the moneys collected from federal securities law violators and maintained by SEC to be distributed to harmed investors. Custodial activities represent the moneys collected by SEC from violators of federal securities laws that are returned to the Treasury, as nonfederal individuals or entities do not have an ownership interest in these revenues.

debts. Because of the limitations of the current case tracking system for disgorgements and penalties, SEC's efforts far exceeded what would have otherwise been necessary to determine the reliability of the data. These efforts will most likely continue until SEC improves its financial system for recording and reporting disgorgement and penalty information.

Even with SEC's increased efforts to address concerns over reporting of disgorgements and penalties, our audit work during fiscal year 2006 continued to identify risks concerning the completeness of the disgorgements and penalties receivable amounts. For example, we identified a $21 million disgorgement case that was erroneously omitted from SEC's disgorgement receivable balance at June 30, 2006. This is largely because SEC's process for determining its disgorgement and penalty receivable balances relies heavily on information being submitted to the Office of Financial Management from individual attorneys working on each case. To compensate for the risk presented by this process, in fiscal year 2006 SEC instituted a compensating control in which the Enforcement office heads were asked to certify the completeness and accuracy of the recorded disgorgement receivable balances at June 30, 2006, and at fiscal year end. Through this certification process, a number of cases were identified as not having current information related to dollar amounts, due dates, and payees, in the case tracking system used to establish the amounts receivable at a given date. While none of these instances resulted in a significant misstatement to the receivable balance reported on the financial statements, relying on a decentralized detective control such as this certification process requires significant analysis, data gathering, and follow up, and increases the risk that disgorgement and penalty debts and related activity may not get recorded in a timely manner or in the proper period.

We are encouraged by SEC's commitment and management attention to strengthening controls over disgorgement and penalty activity to date, as well as SEC's planned future actions in this area. As discussed in it's Management's Discussion and Analysis, SEC has designed procedures and documentation to track disgorgement and penalty actions from the time they are approved by the Commission to their recording in the case tracking system. Also this past year, SEC has begun training attorneys handling the cases on the steps necessary to maintain strong internal controls over updating and communicating information that could impact financial reporting. In addition, in fiscal year 2006 SEC designed a new financial management system for tracking disgorgements and penalties that will replace the financial portion of the existing case tracking system.

SEC expects these new controls and the new disgorgement financial system to be fully operational in fiscal year 2007. Until a permanent and systemic process is fully implemented and operational, SEC does not have sufficient assurance over the accuracy and completeness of its reporting and tracking of disgorgements and penalties.

Information Security

SEC relies extensively on computerized information systems to process, account for, and report on its financial activities and make payments. In order to provide reasonable assurance that financial information and financial assets are adequately safeguarded from inadvertent or deliberate misuse, fraudulent use, improper disclosure, or destruction, effective information security controls are essential. These controls include security management, access controls, change management, segregation of duties, and continuity planning. Although SEC has made important progress in strengthening its controls over financial systems and information and in implementing an agencywide information security program, SEC still needs to implement key elements of the program to remediate existing weaknesses and provide assurance that new weaknesses do not emerge.

SEC has mitigated 51 of 64 control weaknesses that were previously reported as unresolved at the time of our prior review. For example, SEC completed actions to establish policies and procedures for risk management, ensure that all users complete security training, and implement an incident response program. SEC also took corrective action to improve its systems' access rights and permissions, user accounts and passwords, network security, and auditing and monitoring of security-related events. In addition, SEC took immediate steps to address 11 of 15 new weaknesses related to access controls and segregation of duties that we identified during the course of this year's audit.

While we have seen important efforts to improve its information security program, 17 control weaknesses still exist at SEC. For example, SEC has not mitigated weaknesses with user account and password management, provided adequate segregation of system administrative functions, or effectively protected and controlled physical access to its facilities. As a result, sensitive data—including payroll and financial transactions, personnel data, and regulatory and other mission-critical information—remains at risk of unauthorized disclosure, modification, or loss. Until SEC consistently implements all key elements of its information security program, SEC will not have sufficient assurance that financial information and financial assets are adequately safeguarded from inadvertent or deliberate misuse, fraudulent use, improper disclosure, or destruction.

Property and Equipment

SEC's property and equipment consists of software and general purpose equipment used by the agency, capital improvements made to buildings leased by SEC for office space, and internal-use software development costs for projects in development. The reported book value of property and equipment increased from approximately $73 million at September 30, 2005, to nearly $104 million at September 30, 2006. The significant increase in property and equipment is primarily due to SEC occupying new office space in Washington, D.C., Boston, and New York during fiscal year 2006.

During the course of testing fiscal year 2006 additions, we noted numerous instances of inaccuracies in recorded acquisition costs and dates for furniture and equipment purchases, as well as unrecorded furniture and equipment purchases, and errors in amounts capitalized for internal use software projects. These systemic errors did not materially affect the balances reported for property and equipment or the corresponding depreciation/amortization expense amounts in SEC's financial statements for fiscal year 2006; however, these conditions evidence a significant deficiency in control over the recording of property and equipment that impacts the reliability of its recorded balances for property and equipment. Without a process that integrates controls over capitalizing and recording property and equipment purchases, SEC does not have sufficient assurance over the accuracy and completeness of its reported balances for property and equipment.

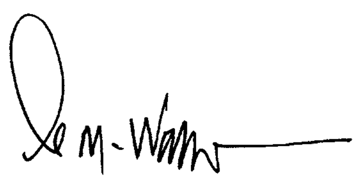
GAO's *Standards for Internal Control in the Federal Government*[6] provide an overall framework for establishing and maintaining internal control, including a discussion of control activities, an example of which is accurate and timely recording of transactions. Specifically, transactions should be accurately and promptly recorded to maintain their relevance and value to management in controlling operations and making decisions. In its Management's Discussion and Analysis, SEC acknowledges the need to strengthen control over this area.

[6] GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1999).

SEC Comments and Our Evaluation

In commenting on a draft of this report, SEC's Chairman said he was pleased to receive an unqualified opinion on SEC's financial statements, and that there were no material weaknesses in internal control. The Chairman acknowledged that further improvements are needed and discussed ongoing and planned efforts to improve controls over disgorgements and penalties, information security, and property management, three areas which we identified as reportable conditions in this year's audit. The Chairman stated that SEC intends to fully remediate all three reportable conditions before the end of fiscal year 2007. SEC's commitment to enhancing its internal controls to ensure reliability of financial reporting, soundness of operations, and public confidence in the agency's mission is key to the Chairman's statement that SEC must lead by example when it comes to compliance with the internal control requirements of the federal and private sectors.

The complete text of SEC's comments is reprinted in appendix I.



David M. Walker
Comptroller General
of the United States

November 6, 2006

CHRISTOPHER COX
CHAIRMAN

HEADQUARTERS
100 F STREET, NE
WASHINGTON, DC 20549

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

November 8, 2006

The Honorable David M. Walker
Comptroller General of the United States
Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Walker:

Thank you for the opportunity to respond to the Government Accountability Office's draft report entitled *Financial Audit: Securities and Exchange Commission's Financial Statements for Fiscal Years 2006 and 2005*. I would like to acknowledge and commend you and the GAO staff for your efforts and dedication in working with the SEC again this year to meet the reporting deadline for our audited financial statements.

I am pleased that the audit found that the statements and notes are presented fairly, in all material respects, and in conformity with U.S. generally accepted accounting principles; that the SEC had effective internal controls over financial reporting and compliance with laws and regulations, although certain controls should be improved; and that there were no instances of reportable noncompliance with laws and regulations tested by GAO.

The SEC made substantial progress in strengthening its internal controls over financial reporting during fiscal 2006. I am pleased that we were successful in resolving each of the three material weaknesses identified in last year's financial audit. As your draft report indicates, further improvements are needed in controls over disgorgement and penalties, information security, and property and equipment. Under the guidance of our Financial Management Oversight Committee, the SEC staff has designed and planned actions to address each of these areas, and we intend to fully remediate all three reportable conditions before the end of fiscal 2007.

We will continue our efforts to evaluate and improve the SEC's controls over the recording and reporting of disgorgement and penalties assessed in enforcement proceedings. During fiscal 2006, the agency took a number of important steps to ensure the integrity of enforcement-related financial data: the Division of Enforcement completed a comprehensive Delinquent Debt Project, which involved verifying the recorded data with respect to all outstanding enforcement debts; we introduced new

CHAIRMANOFFICE@SEC.GOV
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controls over the recording of enforcement receivables; and we completed the design of a new financial management system for tracking disgorgement and penalties that will replace the financial portion of Enforcement's existing case tracking database. In fiscal 2007, we will further strengthen the financial management of all aspects of the enforcement program. The Office of Information Technology expects to roll out the new financial management system by the second quarter, and we are already working on the next steps toward building out a fully-integrated case tracking and financial management system. The SEC will also continue to seek greater efficiencies and to strengthen controls in the management and distribution to investors of fair funds and other distribution funds.

With respect to information security, we will build on the accomplishments of this past year to further enhance the agency's security environment. During fiscal 2006, the SEC implemented a wide variety of new policies and procedures governing the assessment and management of information security risk. These include comprehensive approaches for identifying security risk; configuring, testing, and monitoring information systems; incident response; and remedial action tracking. The SEC also completed the certification and accreditation of its major systems, and conducted awareness training for 99 percent of SEC staff. In addition, we established and tested its disaster recovery and business continuity plans in accordance with recommendations from previous years. In fiscal 2007, the SEC will refine and extend the procedures and management controls to reduce the residual risk. The most important of these will be improvements in the processes for controlling changes to the technical environment, strengthening the management of user accounts and passwords, and measures to tighten the physical perimeter around sensitive areas of the SEC's premises. In addition, the agency will remediate a number of specific technical issues in areas such as patch management, data security, and intrusion detection systems.

Finally, the SEC will make improvements in our processes for reporting on property and equipment. We will update our property management policies to reflect revised business processes, strengthen controls over the recognition of property, and incorporate additional quality checks throughout the year. In addition, we will initiate the process of replacing the SEC's current outdated asset management system to enhance data integrity and maximize the integration of the agency's financial systems.

As Chairman, I am committed to enhancing the SEC's controls in all operational areas, to ensure reliability of financial reporting, soundness of operations, and public confidence in the agency's mission. It is my firm belief that the SEC must lead by

The Honorable David M. Walker
November 8, 2006
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example when it comes to compliance with the internal control requirements of the federal and private sectors. I appreciate your support of those efforts, and look forward to continuing our productive dialogue on the issues addressed in the fiscal 2006 audit.

If you have any questions relating to our response, please contact Margaret Carpenter, Chief Financial Officer, at (202) 551-7854.

Sincerely,

Christopher Cox
Chairman

cc: Jeanette M. Franzel
Director, Financial Management and Assurance
Government Accountability Office

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
INSPECTOR GENERAL

August 28, 2006

To: Honorable Christopher Cox
Chairman

From: Walter Stachnik
Inspector General

Re: Inspector General's Summary of Management Challenges

This report summarizes our view of the most serious management and performance challenges facing the Commission. It was prepared in accordance with the Reports Consolidation Act of 2000. This report is to be included in the Financial Section of the Performance and Accountability Report, which is due to the President, the Office of Management and Budget (OMB), and the Congress by November 15, 2006.

The report was prepared by the Office of Inspector General (Office) in accordance with guidance from OMB. The primary criterion used to select challenges for inclusion was the potential impact of the challenges on the Commission's achievement of its management and performance objectives.

INFORMATION TECHNOLOGY

For many years, the Commission has recognized that it must effectively employ information technology (IT) to achieve its strategic and operational objectives. The integration of IT into Commission work processes and interactions with the public and its partners has been, and continues to be, a critical management challenge.

Although significant improvements have been made, the Office has identified challenges in several key IT areas:

- Information systems security,
- Enterprise architecture management,
- IT capital investment decision making,
- Administration of IT contracts,
- IT project management, and
- Strategic management of IT human capital.

Information systems security remains the most significant of the IT challenges. The Commission and our Office have reported several improvements needed as part of the analysis required by the Federal Information Security Management Act (FISMA). Moreover, the Government Accountability Office (GAO) identified information security as a material weakness, based on its audit of Commission financial statements.

The Commission's Office of Information Technology (OIT) has continued to make progress in implementing improvements in IT. For example, OIT indicated that it has:

- Developed, documented, published, and implemented a comprehensive body of information security policy (as mandated in FISMA),
- Implemented monitoring and reporting controls that consolidate and correlate security events across the agency,
- Implemented an automated reporting system to facilitate complete, accurate and timely FISMA reports,
- Integrated the agency's security architecture into the SEC Technical Reference Model,
- Refined the Commission's Business Reference Model and comprehensive Enterprise Architecture (EA),
- Prepared and submitted the agency's EA Internet Protocol version 6 Transition Plan and inventory to OMB,
- Refined the Commission's EA framework and reference model, and
- Developed a complete and more mature information resource management (IRM) policy framework and governance model to better align the Commission's IT management controls with the mandates of the Clinger-Cohen Act and OMB guidance.

ASSESSMENT AND MANAGEMENT OF RISK

New forms of fraudulent, illegal, and questionable conduct and practices in the securities markets have caused, and continue to pose, serious threats to investors. Detecting and ultimately preventing this conduct and these practices remain a challenge for the Commission. Failure to identify and address these risks timely will be a significant impediment to the complete achievement of Commission program objectives.

The Office of Risk Assessment has introduced or enhanced various initiatives to help advance the agency's risk management capability. These efforts include: leading or coordinating internal teams which address specific issues; designing and initial testing of software for the description and prioritization of risks; initial testing of statistical techniques to identify certain types of risk; and assessing emerging trends though workshops for the staff, meetings with industry experts and other regulators, and the review of professional and academic research.

FINANCIAL MANAGEMENT

The Government Accountability Office's (GAO) fiscal year 2005 audit of Commission financial statements found that the financial statements were presented fairly, in all material respects, and in conformity with U.S. generally accepted accounting principles for federal agencies, and that it found no instances of reportable noncompliance with laws and regulations tested. However, GAO again reported three material weaknesses: recording and reporting of disgorgements and penalties, information security (discussed in the section on Information Technology above), and preparing financial statements and related disclosures.

With respect to the recording and reporting of disgorgements and penalties, the Commission needs to finish the development of comprehensive policies and implement internal controls for the collection of enforcement-based financial transactions. A new subsidiary system for disgorgements and penalties is set to be completed by the end of 2006 and business processes, practices, and policies will need to be redesigned.

Preparation of financial statements continues to be manually intensive, consuming excessive staff resources, and lacking complete documentation of quality controls and accounting policies and procedures. The Office of Financial Management is scheduled to implement additional accounting policies by next year. These include expanded monthly reconciliations, new year-end and quarterly closing procedures, and regular review by key management of financial reports and operations.

Budget planning and execution controls also need improvement. Failure to adequately budget for $48.7 million dollars in construction costs for new Commission leased facilities in Washington, New York, and Boston was caused by ineffective budget management controls, inadequate administrative infrastructure, and the nature of the facilities, according to a GAO review. Moreover, budgetary pressures to "do more with less" make this challenge even more critical. The Commission has scheduled implementation of all the review recommendations by the end of 2006.

HUMAN CAPITAL

The Commission operates in a challenging human capital environment. To fully achieve its human capital objectives, Commission human capital strategies must be aligned with the agency's mission, program objectives, and outcomes. While progress has been realized in achieving this alignment, it remains a management challenge for the Commission.

To achieve the Commission's human capital objectives, the Office of Human Resources (OHR) is working to implement and integrate a set of human capital systems, including systems for performance management, selection, leadership and knowledge management, and succession planning. It is also working to develop and implement the agency's first stand-alone Strategic Human Capital Plan to guide the achievement of human capital objectives and the management and dissemination of knowledge throughout the agency.

APPENDIX A: SEC OFFICES

HEADQUARTERS OFFICES

Division of Corporation Finance
John W. White, Director
(202) 551-3000

Division of Enforcement
Linda C. Thomsen, Director
(202) 551-4500

Division of Investment Management
Andrew J. Donohue, Director
(202) 551-6865

Division of Market Regulation
Eric R. Sirri, Director
(202) 551-5500

Office of the Chief Accountant
Conrad W. Hewitt,
Chief Accountant
(202) 551-5300

Office of Public Affairs
John Nester, Director
(202) 551-4120

Office of International Affairs
Ethiopis Tafara, Director
(202) 551-6690

Office of Legislative Affairs
Jane O. Cobb, Director
(202) 551-2010

Office of the Secretary
Nancy M. Morris, Secretary
(202) 551-5400

Office of Investor Education and Assistance
Lori Schock, Acting Director
(202) 551-6551

Office of Risk Assessment
Charles Fishkin, Director
(202) 551-4350

Office of the Inspector General
Walter J. Stachnik,
Inspector General
(202) 551-6060

Office of Human Resources
Jeffrey Risinger, Director
(202) 551-7500

Office of Information Technology
R. Corey Booth, Director
(202) 551-8800

Office of the Executive Director
Diego T. Ruiz, Executive Director
(202) 551-4300

Office of Economic Analysis
Chester Spatt, Chief Economist
(202) 551-6600

Office of Filings and Information Services
Jayne L. Seidman,
Acting Associate
Executive Director
(202) 551-7200

Office of Compliance Inspections and Examinations
Lori A. Richards, Director
(202) 551-6200

Office of Equal Employment Opportunity
Deborah K. Balducchi, Director
(202) 551-6040

Office of Administrative Law Judges
Brenda P. Murray, Chief
Administrative Law Judge
(202) 551-6030

Office of Administrative Services
Annie O'Donoghue,
Associate Executive Director
(202) 551-7400

Office of Financial Management
Margaret J. Carpenter,
Associate Executive Director
(202) 551-7840

Office of the General Counsel
Brian G. Cartwright,
General Counsel
(202) 551-5100

Freedom of Information and Privacy Act
Celia Winter, FOIA Officer
(202) 551-8300

REGIONAL AND DISTRICT OFFICES

Northeast Regional Office
Mark Schonfeld,
Regional Director
3 World Financial Center
Room 4300
New York, NY 10281
(212) 336-1020
e-mail: newyork@sec.gov

Boston District Office
David P. Bergers,
District Administrator
33 Arch Street, Floor 23
Boston, MA 02108-02110
(617) 573-8900
e-mail: boston@sec.gov

Philadelphia District Office
Daniel Hawke,
District Administrator
The Mellon Independence Center
701 Market Street
Philadelphia, PA 19106-1532
(215) 597-3100
e-mail: philadelphia@sec.gov

Southeast Regional Office
David Nelson, Regional Director
801 Brickell Avenue, Suite 1800
Miami, FL 33131
(305) 982-6300
e-mail: miami@sec.gov

Atlanta District Office
District Administrator
3475 Lenox Road, N.E.
Suite 1000
Atlanta, GA 30326-1232
(404) 842-7600
e-mail: atlanta@sec.gov

Midwest Regional Office
Merri Jo Gillette,
Regional Director
175 W. Jackson Boulevard
Suite 900
Chicago, IL 60604
(312) 353-7390
e-mail: chicago@sec.gov

Central Regional Office
George B. Curtis,
Regional Director Designate
1801 California Street
Suite 1500
Denver, CO 80202-2656
(303) 844-1000
e-mail: denver@sec.gov

Fort Worth District Office
Rose L. Romero,
District Administrator
801 Cherry Street, 19th Floor
Fort Worth, TX 76102
(817) 978-3821
e-mail: dfw@sec.gov

Salt Lake District Office
Kenneth D. Israel, Jr.,
District Administrator
15 W. South Temple Street
Suite 1800
Salt Lake City, UT 84101
(801) 524-5796
e-mail: saltlake@sec.gov

Pacific Regional Office
Randall R. Lee,
Regional Director
5670 Wilshire Boulevard
11th Floor
Los Angeles, CA 90036-3648
(323) 965-3998
e-mail: losangeles@sec.gov

San Francisco District Office
Helane L. Morrison,
District Administrator
44 Montgomery Street
Suite 1100
San Francisco, CA 94104
(415) 705-2500
e-mail: sanfrancisco@sec.gov

This Performance and Accountability Report was produced with the energies and talents of the SEC staff. To these individuals we offer our sincerest thanks and acknowledgement. We would also like to acknowledge the Government Accountability Office and the SEC's Office of Inspector General for the professional manner in which they conducted the audit of the Fiscal Year 2006 Financial Statements. Finally, we offer special thanks to Deva & Associates, P.C. and Financial Communications Inc. for their outstanding contributions in the design and production of this report.

To comment on, or obtain additional copies of the SEC's FY 2006 Performance and Accountability Report, please send an e-mail to: SECPAR@sec.gov.

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549