

U.S. SECURITIES AND EXCHANGE COMMISSION

Protecting Investors



U.S. SECURITIES AND EXCHANGE COMMISSION
100 F STREET, NE
WASHINGTON, DC 20549

2004 PERFORMANCE AND ACCOUNTABILITY HIGHLIGHTS

Vision

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

“We want our efforts to be more anticipatory and preventative in nature—to look over the hills and around the corners of the securities markets.”

—William H. Donaldson
SEC Chairman



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



Values

Integrity • Fairness

Accountability • Resourcefulness

Teamwork • Commitment to Excellence



Message from the Chairman

I am pleased to present the *Performance and Accountability Report of the U.S. Securities and Exchange Commission* for the fiscal year ended September 30, 2004. This report presents the agency's financial condition and results of operations for the past fiscal year and details our performance in meeting the goals established in our most recent strategic plan. Because we oversee the accounting and auditing profession, in order to avoid any perceived conflict of interest, the U.S. Securities and Exchange Commission (SEC) chose to have its financial statements audited by the U.S. Government Accountability Office (GAO). I am pleased to report that the GAO has affirmed that the SEC's financial statements were presented fairly in all material respects, in conformity with U.S. generally accepted accounting principles. This outcome is an impressive achievement considering that this was the first-ever audit of the SEC's financial statements.

Furthering Our Mission

The SEC's mission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. Today's financial, investing, and corporate environment demands that the SEC be proactive and creative in approaching its mission. To be successful, the SEC must anticipate and appropriately respond to increasing industry growth and complexity, the public's increasing interest and participation in the securities markets, ongoing technological and market structure changes, and the continued internationalization of our markets.

When I became Chairman of the SEC over two years ago, our nation's corporate landscape was littered with major corporate scandals and ethical lapses. This environment brought into question the fundamental fairness and integrity of our markets and led to a significant decline in investor confidence. Since that time, and with Congress' leadership as exemplified by the Sarbanes-Oxley Act of 2002, the SEC has focused on holding accountable those who have violated the public trust. We have taken actions intended to make the markets

more efficient and transparent and have actively promoted responsible and independent corporate governance, thereby helping to restore investor confidence.

The SEC has worked to achieve these objectives by, among other things, strengthening our enforcement and examination programs. We have begun to pursue a proactive, risk-targeted approach to detecting wrongdoing, and we have obtained a record amount of penalties and disgorgement in SEC enforcement actions. The agency also addressed serious abuses that were identified within the mutual fund industry through the vigorous implementation of broad-based reforms to address the recent market timing and late trading abuses.

The SEC has spearheaded several initiatives relating to the structure of our markets and the governance practices of self-regulatory organizations, including the proposal of Regulation NMS (adopted in fiscal 2005), a broad re-examination of the fundamental regulatory structure of the U.S. equity markets, as well as an initiative that resulted in significant changes to the governance of the New York Stock Exchange. The agency also has worked to meet the Sarbanes-Oxley Act's once-every-three-years review cycle for registered public companies and investment companies, and supported additional rules designed to improve financial disclosures.

Fundamental to these achievements has been the hiring of more than 1,000 new employees between fiscal years 2002 and 2004, the largest staffing increase in the agency's history. The SEC also implemented organizational changes and enacted other management reforms to help the agency become as sophisticated, flexible, and dynamic as the securities markets it regulates. The SEC launched this process by conducting a top-to-bottom review of the agency, and then set out to inject new thinking and to inspire a new vision—one that would help us focus more on anticipating risks, rather than arriving at the scene only after a financial crisis or corporate scandal has occurred.

The SEC has initiated efforts to improve its ability to "look over the hills and around the corners" for the next emerging problem by creating a new Commission-wide risk assessment and management program, featuring a new Office of Risk Assessment, as well as a new program of comprehensive risk identification throughout the agency. This program involves each office and division and includes multi-disciplinary risk teams covering the areas of full disclosure; investment management and market regulation; and infrastructure. While relatively new, I believe that all of these reforms will have a profound and long-lasting impact on the way business is done at the SEC and in our financial markets.

Leading by Example

The SEC also must lead by example with respect to the internal controls requirements demanded of the private and federal sectors. The SEC has examined its own internal controls under the Federal Managers' Financial Integrity Act of 1982. In December 2004 I reported to the President, providing qualified assurance (consistent with OMB guidance) that, taken as a whole, the agency's system of controls is achieving its objectives under Section 2 of the Act. This Performance and Accountability Report provides additional information on internal control weaknesses that are described below. I also am pleased to confirm that the performance information that we are reporting is complete and reliable in all material respects and satisfies the guidance provided by the Office of Management and Budget. Additionally, the SEC is in compliance in all material respects with all applicable laws and regulations as they relate to federal financial reporting.

The SEC is taking appropriate steps to begin to address all weaknesses that GAO and we have identified, including three material weaknesses in internal controls. The material weaknesses in internal controls relate to the security of our information technology environment; our management of disgorgement and civil monetary penalties; and certain other aspects of the agency's financial reporting practices.

With respect to the SEC's information technology security program, the SEC has, among other things, begun a certification and accreditation project to ensure that all major operating systems are secure, and has initiated revisions to the agency's information security control documents and policies, procedures, and guidelines as mandated by the Federal Information Security Management Act. The SEC also has made significant progress in improving its practices with respect to civil monetary penalties and disgorgement. In particular, the agency has begun a project to replace the current case tracking system, which contains most of the financial data on civil monetary penalties and disgorgement, and is working diligently to ensure that data entered into the current system is complete, timely, and accurate. The SEC also will strengthen internal controls over its financial statement preparation processes by, among other things, completing documentation which is necessary to support the procedures, systems, and analysis of accounts involved in developing key balances and preparing financial statements.

With the continued support of the President and the Congress, the SEC is making great strides in restoring investor confidence and strengthening the agency's operations. The SEC's successes during the past year are due to the hard work of its outstanding staff: a select corps of professionals dedicated to our mission of preserving the integrity of America's securities markets. Given the importance of the SEC's mission and activities to the nation's economy and the investing public, the agency will not waver in pushing for further progress in the years ahead.

Sincerely,

William H. Donaldson
Chairman
May 2005

At a Glance

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 ownership society.

This document contains the Management's Discussion and Analysis section from the SEC's Fiscal Year (FY) 2004 *Performance and Accountability Report* (PAR). A PDF version of the complete PAR is contained on a CD-ROM at the back of this document, or can be accessed on the SEC's website at www.sec.gov/about/secpar.shtml.



From left to right: Commissioners Paul S. Atkins, Cynthia A. Glassman, William H. Donaldson, Harvey J. Goldschmid, and Roel C. Campos.

Organizational Structure

The SEC is an independent federal agency that 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 U.S. Senate. The SEC operates under the authority of federal laws, including the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, the Investment Advisers Act of 1940, and the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act), among others.

At the end of FY 2004, the SEC had more than 4,000 permanent and more than 70 temporary staff positions. The SEC is organized into four divisions and 21 offices, with its headquarters in Washington, D.C. In addition, the Commission maintains 11 regional and district offices throughout the country.

Goals

The SEC updated its four agency-wide goals to achieve desired outcomes, along with its vision, mission, and values, as part of its new strategic plan for FY 2004 through FY 2009.

To enforce compliance with federal securities laws. The Commission seeks to detect potential problems or issues in the securities markets early and prevent violations of federal securities laws. If violations occur, the SEC alerts investors to possible wrongdoing and takes prompt action to halt and sanction the misconduct.

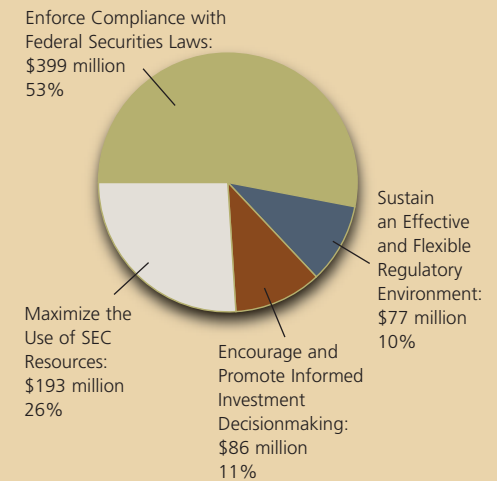
To sustain an effective and flexible regulatory environment. Federal securities laws seek to promote fair, orderly, and competitive markets that protect investors from undisclosed risk while fostering innovation and market access. The Commission's role is to establish a regulatory environment that both protects investors and permits competition to flourish.

To encourage and promote informed investment decisionmaking. An educated investor ultimately provides the best defense against fraud and costly mistakes. The SEC works to promote informed investment decisions through two main approaches—reviewing disclosures to help ensure clear, complete, and truthful information is provided to the investing public, implementing a variety of investor education initiatives.

To maximize the use of SEC resources. An efficient, well-managed, proactive SEC is critical for protecting investors and the markets. As such, the Commission concentrates on enhancing organizational effectiveness, investing in its human capital, as well as new technologies, and strengthening internal controls.

SEC FY 2004 Obligations by Strategic Goal

The SEC's FY 2004 authorized budget was \$811.5 million, of that amount \$755 million was obligated across its four strategic goals.




New Rules for Today's Markets

The SEC launched several initiatives to improve disclosure to investors.

This year marked the second anniversary of the Sarbanes-Oxley Act and was the opening season for filings reflecting major aspects of the Sarbanes-Oxley Act. The Commission completed on schedule the last of the ten rulemaking projects that the Sarbanes-Oxley Act required. The Commission also fulfilled its ongoing responsibilities to supervise the Public Company Accounting Oversight Board (PCAOB) and its regulation of auditors of public companies.

In FY 2004, the Commission approved the PCAOB's code of ethics, process for setting auditing standards, and annual budget. As required under the Sarbanes-Oxley Act, the Commission conducted independent rulemaking before approving the PCAOB's auditing standards, including Standard No. 2, which outlines requirements for audits of companies' internal controls over financial reporting.



Elizabeth M. Murphy, Office Chief in the Division of Corporation Finance, has over 18 years of service with the SEC and received the Commission's Award for Supervisory Excellence. Ms. Murphy and her office drafted rules covering internal controls over financial reporting and "real-time" disclosure of extraordinary corporate events.

The Commission launched several regulatory initiatives to improve disclosures to investors so they can make better-informed investment decisions.

The Commission also launched several regulatory initiatives to improve disclosures to investors so they can make better-informed investment decisions. Highlights of this rulemaking agenda included the following:

“Tagged Data.” The Commission solicited comment on a rule allowing voluntary supplemental filings of financial data using eXtensible Business Reporting Language, beginning with the 2004 calendar year-end reporting season. This proposal is part of a broad, multi-year initiative to assess the benefits of tagged data, which could dramatically improve the ability of investors and SEC staff to analyze issuers’ financial data.

Asset-Backed Securities. In FY 2004, the Commission released a package of proposals updating the registration, reporting, and disclosure requirements for asset-backed securities (ABS). In less than 25 years, SEC-registered ABS have become an important segment of the fixed-income capital markets, with annual public issuance of up to \$800 billion. These proposals set new disclosure requirements that are more relevant for ABS transactions, as the current requirements are designed primarily for corporate issuers and therefore do not always provide information that is material to the ABS market.

Deterring Fraud and Abuse by Shell Companies. The Commission proposed rules to prohibit the use of Form S-8 by shell companies for capital-raising transactions. Also, the proposal would provide more appropriate and timely information for “reverse mergers” and “back door registrations.”

Proxy Access. The Commission proposed a new rule that would require the inclusion of shareholder nominees in the company’s proxy materials under limited circumstances. Overly compliant boards of directors at times have allowed management unfettered control over the proxy process and other critical

governance issues. This proposal attempts to find a middle ground between forcing shareholders to give up their long-term interest in the company and sell their stock, on the one hand, and forcing them to wage a wasteful proxy fight on the other.

During FY 2004, the Commission continued to improve its disclosure review program. Under the Sarbanes-Oxley Act, the SEC is required to review each reporting company and each investment company issuer at least once every three years. While the SEC was unable to review as many reporting companies during the first two years of this three-year cycle as anticipated due to its inability to quickly hire and train additional staff, it did strengthen its review processes by adopting new approaches to selecting filings for review and focusing its resources on material issues in filings. The Division of Corporation Finance also continued its review focus for the second year on the largest public companies, which required the most substantial resources.

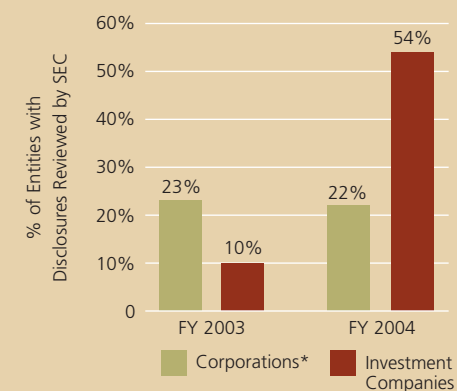
With these enhancements, the Division of Corporation Finance is working diligently to meet this Sarbanes-Oxley Act requirement. In addition, during FY 2004, the SEC reviewed disclosures for 54 percent of all investment companies and is on track to review 100 percent by the end of the first three-year cycle.

During FY 2004, the SEC oversaw the accounting standard-setting process as the Financial Accounting Standards Board made progress on several major projects, such as the consolidation of variable-interest entities, accounting for stock compensation arrangements, and accounting for business combinations. In FY 2004, the SEC expanded its efforts to monitor standards development by the International Accounting Standards Board to promote the convergence of U.S. and foreign accounting standards and facilitate cross-border securities offerings.

The SEC also created an Office of Global Security Risk within the Division of Corporation Finance to identify companies engaging in activities that raise global security and humanitarian concerns that are material to investors.

New Performance Measure: Percentage of Corporations and Investment Companies with Disclosures Reviewed by the SEC

Description: The Sarbanes-Oxley Act requires that the SEC review the disclosures of all corporations and investment companies at least once every three years. These reviews help improve the disclosure information available to investors and can uncover serious violations of the federal securities laws. This performance measure identifies the percentage of corporations and investment companies reviewed each year during the first three-year cycle under the Sarbanes-Oxley Act.



* Some corporations were reviewed in both FY 2003 and 2004, and have been counted in both years.

Analysis of Results: The Division of Investment Management reviewed more than half of investment companies in FY 2004 alone and is on track to review 100 percent by the end of the first three-year cycle. The Division of Corporation Finance continued its review focus on the largest public companies, and has not reviewed as many issuers as anticipated during the first two years of this three-year cycle. In the past two years, the Division of Corporation Finance experienced difficulties hiring the 175 additional staff, particularly accountants, needed to conduct the necessary reviews. With the assistance of the excepted service hiring authority that the SEC received in July 2003 and the enlistment of two nationally recognized executive recruiting firms, the Division of Corporation Finance was nearly finished with its hiring at the end of FY 2004, and is working diligently to review 100 percent of corporations by the end of this three-year cycle.



A Market Structure Brought Up to Date

A series of SEC reforms address new technologies and trading practices.

In FY 2004, the Commission pursued an extensive and ambitious agenda to improve the structure and governance of the U.S. securities markets. For example, after the SEC asked each of the self-regulatory organizations (SROs) to review the adequacy of their governance practices the New York Stock Exchange (NYSE) issued a series of proposals to enhance its governance. These proposals, approved by the Commission in December 2003, included the creation of the following: a smaller, independent board of directors; four key board committees overseeing certain critical functions; and an autonomous regulatory office headed by a Chief Regulatory Officer. The Commission is carefully considering proposals to tighten SRO governance further and ensure that SROs are performing their regulatory obligations.

Over the last few decades, the facilities and rules that link our securities markets have been tested severely by new technologies and trading patterns. In February 2004, the Commission published for public comment Regulation National Market System (NMS), a far-reaching set of proposals designed to improve

Sapna C. Patel, Special Counsel in the Division of Market Regulation's Office of Market Supervision, has been with the SEC for four years and is a recipient of the SEC's Manuel F. Cohen Award. Ms. Patel is helping the SEC address market structure, corporate governance, and trading platform issues.

New Performance Measure:

Milestones Achieved for High-Priority Rulemakings

Description: For FY 2004, the Commission and staff set ambitious goals to propose or adopt several major rulemaking activities covering a wide range of topics. This agenda included proposals to enhance significantly the regulations governing the mutual fund industry, modernize the structure of the U.S. securities markets, and register hedge fund advisers. This performance measure gauges whether the SEC successfully implemented its major regulatory goals during FY 2004.

RULEMAKING	PLAN	ACTION TAKEN
Investment Management		
Market Timing and Selective Disclosure	Propose & Take Final Action	Adopted
Breakpoint Sales Load Disclosure	Propose & Take Final Action	Adopted
Directors' Approval of Advisory Contracts	Propose & Take Final Action	Adopted
Portfolio Manager Disclosure	Propose & Take Final Action	Adopted
Investment Adviser Codes of Ethics	Propose & Take Final Action	Adopted
Mutual Fund Governance Rules	Propose & Take Final Action	Adopted
Prohibit Use of Brokerage Commissions to Finance Distribution of Mutual Funds	Propose & Take Final Action	Adopted
Fund and Adviser Compliance Programs	Take Final Action	Adopted
Hedge Fund Adviser Registration	Propose	Proposed
Redemption Fee for Mutual Funds	Propose	Proposed
Pricing of Mutual Fund Shares	Propose	Proposed
Corporation Finance		
Shareholder Nomination System	Propose	Proposed
Asset-Backed Securities	Propose	Proposed
Securities Act Reform	Propose	Proposed
Shell Companies	Propose	Proposed
8-K Disclosure Enhancements	Take Final Action	Adopted
"Tagged Data"	Propose	Proposed
Market Regulation		
National Market Structure	Propose	Proposed
Short Sale Regulation	Propose	Adopted
Consolidated Supervised Entities	Propose	Adopted
Point-of-Sale Disclosure/ Confirmation Requirements	Propose	Proposed
Regulation B	Propose	Proposed

Analysis of Results: The Commission and its staff implemented all of the planned actions related to major rulemaking proposals. Among other goals, these rules were designed to combat mutual fund market timing and late trading practices, improve the compliance culture of investment companies and advisers, modernize the regulatory structure of the U.S. equity markets, and provide a comprehensive registration and disclosure regime for ABS. As a result, these rules address many of the most important challenges facing the securities markets and will have significant effects for years to come. As the SEC finishes this major wave of rulemaking activities, the SEC will work to devise ways to measure these effects over time.

and modernize the regulatory structure of the U.S. equity markets. Regulation NMS covers four substantive areas: trade-throughs, market access, sub-penny quoting, and market data. The SEC is currently reviewing more than 700 comment letters received to date on proposed Regulation NMS and intends to take final action on the rules in FY 2005.

The Commission moved to reform short sale regulations and to address abusive "naked short selling." These rules imposed a requirement that broker-dealers, prior to effecting a short sale of any equity security, must "locate" securities available for borrowing so that the security can be delivered on the settlement date. The Commission approved additional delivery requirements for certain equity securities with substantial delivery failures. Also included in the new rule was a one-year pilot program for specified securities that temporarily suspends the operation of the "tick test" and other short sale price tests. The pilot will assist the Commission in examining the current price test structure and considering alternatives for future short sale regulation.

The Commission established a new regime for overseeing the capital requirements of the largest international financial conglomerates. In April 2004, the Commission adopted a new program that established a voluntary, alternative method of computing deductions to net capital for certain broker-dealers. As a condition of a broker-dealer's use of this alternative method, the broker-dealer and its holding company and affiliates, collectively referred to as a consolidated supervised entity, must consent to group-wide Commission supervision, including record-keeping and reporting requirements.

In January 2004, the Commission proposed two new rules to provide point-of-sale disclosure and improve confirmation disclosure related to sales fees and conflicts of interest arising from the distribution of mutual funds, 529 plans, and related securities. The SEC received over 1,000 comments on these proposals, underscoring the intense level of interest in this area from investors and the securities industry. The SEC is carefully examining those comments and intends to develop final rules that will provide investors with timely, practical, and cost-effective information about distribution costs and conflicts of interest.

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A man with glasses, wearing a blue dress shirt and a red and blue striped tie, is leaning on a metal railing. He is smiling slightly and looking towards the camera. The background is a modern office interior with large windows and warm lighting.

A Stronger Framework for Mutual Funds and Investment Advisers

Fund governance reform and enhanced internal oversight of fund activities are among the many improvements made to the mutual fund and investment advisers industries.

In FY 2004, the SEC led a prompt and multi-pronged response to identified abuses in the mutual fund industry. In addition to aggressive enforcement activity and broad-based, risk-targeted examinations, the SEC strengthened the mutual fund oversight and regulatory framework to minimize the possibility of potential abuse in the future. These actions helped restore investor confidence in the industry.

Brian D. Bullard, Chief Accountant in the Division of Investment Management, has been with the SEC for over five years and is a recipient of the SEC's Andrew Barr Award. Mr. Bullard has been closely involved in rulemaking initiatives and enforcement investigations in response to abuses in the mutual fund industry and auditor independence issues concerning investment companies.

In July 2004, the Commission voted to propose registering hedge fund advisers.



Among the many major regulatory initiatives related to the mutual fund industry in FY 2004, the Commission accomplished the following:

- Adopted a comprehensive package of fund governance rules that will require, among other things, an independent board chairman and a board comprised of 75 percent independent directors. These rules are designed to bolster the effectiveness of independent directors and solidify the role of the fund board as the primary advocate for fund shareholders.
- Adopted rules to require that all registered investment advisers adopt codes of ethics and that funds and their advisers have comprehensive compliance policies and procedures in place, including the appointment of a designated Chief Compliance Officer. These rules are designed to reinforce the fundamental importance of integrity and compliance with the federal securities laws in the investment management industry.
- Enhanced mutual fund disclosure by requiring more frequent disclosure of portfolio holdings, requiring that shareholder reports include dollar-based expense information, improving disclosure regarding a portfolio manager's potential conflicts of interest with the fund, requiring improved disclosure of breakpoint discounts, and proposing significant amendments to the information that a broker-dealer provides its customers in connection with mutual fund transactions.

- Adopted an amendment to rule 12b-1 to prohibit the use of brokerage commissions to compensate broker-dealers for the distribution of a fund's shares. This step will eliminate a practice that potentially compromises the best execution of a fund's portfolio trades, increases portfolio turnover, and biases broker-dealers' recommendations to their customers.
- Proposed to address late trading abuses by permitting same-day pricing for fund orders only if they are received by the fund, its designated transfer agent, or a registered clearing agency before the fund's designated pricing time.
- Put forth a series of initiatives to address market timing, especially so-called "arbitrage" market timing. The initiatives include improved fair value pricing disclosure, enhanced disclosure regarding a fund's anti-market timing policies and practices, and a proposal that funds impose a mandatory two percent redemption fee when investors redeem their shares within five days of purchase.

In July 2004, the Commission voted to propose registering hedge fund advisers. Hedge fund managers are, directly and indirectly, providing advisory services for many U.S. investors with significant impact not only on the investors but also on the operation of the U.S. securities markets. In addition, intermediaries are purchasing hedge funds on behalf of millions of smaller investor beneficiaries, such as retirees, pensioners, and others not generally thought of as the traditional hedge fund investor. The increased use of hedge funds in pension plans or other funds makes it critical that the Commission has basic information about the activities of hedge fund managers. In October 2004, the Commission voted to adopt this proposal.



The Commission approved a rule requiring funds to have an independent chairman, and that 75 percent of its board members must be independent.

Reinforcing a Culture of Compliance

Enhancing examination and enforcement efforts through risk-targeted and proactive approaches for detecting wrongdoing.

As a result of recent increases in staff and resources, the SEC significantly improved its efforts to enforce compliance with the federal securities laws. These efforts have two main components: inspecting regulated entities to promote compliance and uncover violations, and investigating and litigating violations of law.

In FY 2004, the SEC's examination program launched a variety of initiatives to significantly enhance its oversight of the investment management industry, broker-dealers, and SROs. As part of the Chairman's risk assessment initiative, the Office of Compliance Inspections and Examinations enlisted front-line



Standing: **Tracy Linkins Price**, Branch Chief for the Division of Enforcement, has worked with the SEC for over seven years and received the SEC's Capital Markets Award for investigating research analyst conflicts of interest. Ms. Linkins Price's investigations resulted in an \$87.5 million judgment against one firm and multiple settlements against brokerage firms for undisclosed payments for research.

Seated: **Arthur Stoll**, Branch Chief for the Midwest Regional Office's Branch of Investment Management Examinations, has nearly ten years of service with the SEC and received the Examination Award of Excellence. Mr. Stoll has worked on several enforcement referrals resulting from investment adviser and investment company inspections.

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examiners across the country to identify major and emerging risks throughout the industry. The Office of Compliance Inspections and Examinations then addressed these risk areas in part through dozens of special examinations targeted at those risks, called risk-targeted sweeps. Topics included mutual fund market timing and late trading, use of fair value pricing by international funds, fixed-income mark-ups, and the misuse of non-public information from Private Investment in Public Equity structures and loan syndicates. As a result of these risk-targeted sweeps, the number of significant deficiencies detected by the Office of Compliance Inspections and Examinations increased, and needed regulatory improvements were recommended.

In FY 2004, significant compliance problems found by the examination program included the following:

“Directed Brokerage and Revenue Sharing.” Examinations revealed that fund assets increasingly were being used for sales and marketing payments to broker-dealers outside of rule 12b-1 distribution agreements. These findings resulted in SEC enforcement actions, a new Commission rule barring funds from using brokerage commissions to pay marketing incentives to broker-dealers, and an SEC rule proposal that would require greater point-of-sale disclosure to customers about the incentives received by broker-dealers to sell a particular fund.

Violations by Specialists. Examinations revealed that NYSE specialists were “trading ahead” of their customers’ orders. This finding resulted in SEC and NYSE enforcement actions against NYSE specialist firms.

Disclosure and suitability problems in the sale of variable annuities. Examinations revealed that many broker-dealers were selling variable annuities without adequately disclosing their

features, to individuals for whom these products were unsuitable, and with poor supervision and training. These findings led to the issuance of a public report by the SEC and the National Association of Securities Dealers (NASD), describing poor and best practices for broker-dealers in this area, and an NASD rule proposal designed to ensure better disclosure and sales practices.

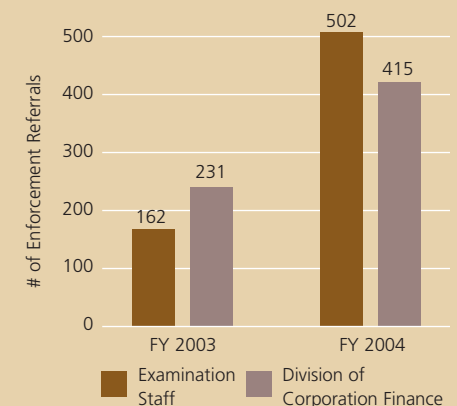
Broker-dealers’ failure to provide “breakpoint” discounts. An examination sweep by the SEC, NASD, and NYSE found widespread failures to provide “breakpoint” discounts to customers. The sweep resulted in the creation of an industry task force that identified systemic solutions, a new SEC rule to better disclose available “breakpoint” discounts, and SEC and NASD enforcement actions.

The extent of “market timing” and late trading in the mutual fund industry. After initial indications that mutual funds had collusive market timing arrangements with certain hedge funds and other traders, SEC examiners conducted a large-scale examination sweep of hundreds of firms to identify the scope of the problem. As a result of the risk-targeted sweeps, enforcement actions have been brought against ten mutual fund complexes to date, and others are still under investigation.

Lack of strong internal controls in the sale of certain structured finance products. After Enron and other financial frauds, examiners worked together with federal banking regulators to inspect broker-dealers and banks involved in the structuring and sale of these products. Together, the SEC and the federal banking regulators proposed for public comment various internal controls that firms should adopt.

**New Performance Measure:
Significant Deficiencies Detected and Referrals to the Division of Enforcement from Examination Staff or the Division of Corporation Finance**

Description: The SEC’s Division of Enforcement receives referrals that come from a variety of sources including SEC staff referrals. Both the Division of Corporation Finance and the Office of Compliance Inspections and Examinations strive to uncover serious potential deficiencies and violations of the federal securities laws through the SEC’s disclosure review and examination programs. When possible deficiencies or violations are found, they may be referred to the SEC’s Division of Enforcement for further investigation. This performance measure tracks the number of enforcement referrals arising from significant deficiencies detected by the examination staff and the Division of Corporation Finance’s disclosure review program by fiscal year. During FY 2004, the Office of Compliance Inspections and Examinations used enforcement referrals as a proxy for significant deficiencies detected. In FY 2005, data on the number of significant deficiencies detected will be collected and reported.



Analysis of Results: Increases in the number of significant deficiencies detected by the examination staff can be attributed in part to the shift in the examination program’s emphasis from routine inspection cycles to a more risk-based approach. In FY 2004, examination staff identified hundreds of possible risks to investors and then conducted risk-targeted sweeps directed at the most salient risks to investors, an approach that uncovered many more potentially serious violations than in previous years. With respect to the Division of Corporation Finance, enforcement referrals rose in part due to the delinquent filer program, in which dozens of issuers who failed to make disclosure filings as required under federal law were identified.



In total, the staff instituted about 375 administrative proceedings and 264 civil proceedings, prevailing in the great majority of the enforcement actions decided by district courts or administrative law judges.



The SEC's enforcement program, including its regional offices, increased its staffing by approximately 29 percent between FY 2003 and 2004 as a result of increased funding authorized by the Sarbanes-Oxley Act. With these new employees, the SEC's enforcement staff opened approximately 950 investigations, particularly with respect to mutual funds, investment advisers, and the mutual fund sales practices of broker-dealers. The following is a sampling of the year's significant enforcement actions:

Mutual fund market timing, late trading, and selective disclosure actions. The Commission brought 29 actions against participants in the mutual fund industry, including Pilgrim Baxter & Associates, Putnam Investment Management, Alliance Capital Management, Massachusetts Financial Services, and Strong Capital Management. For such cases, the Commission ordered a total of \$552 million in disgorgement and \$480 million in penalties, which will be distributed to injured investors through the "Fair Funds" provision of the Sarbanes-Oxley Act.

The specialists cases. The Commission and the NYSE found that five specialist firms executed orders for their dealer accounts ahead of executable public customer or "agency" orders. In settling, the firms agreed to pay a total of \$247 million in penalties and disgorgement and improve compliance procedures.

SEC v. Lucent Technologies Inc., et al. The Commission charged Lucent Technologies and certain current and former Lucent officers, executives, and employees, and alleged that the company fraudulently and improperly recognized about \$1.1 billion of revenue and \$470 million in pre-tax income

during FY 2000. Lucent and three of its former employees agreed to settle the case. The company agreed to pay a \$25 million penalty for its lack of cooperation.

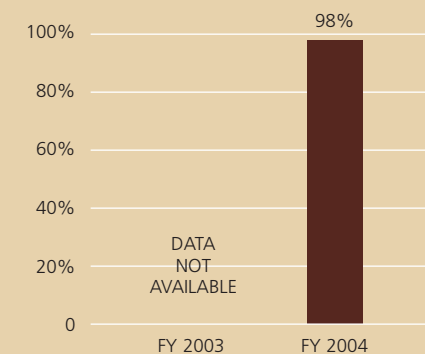
SEC v. Computer Associates International Inc.; SEC v. Sanjay Kumar and Stephen Richards; and SEC v. Steven Woghin. The Commission filed seven separate actions against Computer Associates and seven former top executives alleging that Computer Associates, one of the world's largest software companies, prematurely recognized revenue totaling over \$3 billion, and that the former executives obstructed the Commission's investigation. In addition to other relief, over \$225 million was ordered to be returned to shareholders.

SEC v. Royal Dutch Petroleum Company and The "Shell" Transport and Trading Co., PLC; In the Matter of Royal Dutch Petroleum Company and The "Shell" Transport and Trading Co., PLC. The Commission filed enforcement proceedings against two foreign-based oil companies in connection with their overstatement of 4.47 billion barrels of previously reported proved hydrocarbon reserves. In settlement of these actions, the defendants consented to a cease and desist order and to, among other things, payment of \$120 million in penalties.

In total, the staff instituted about 375 administrative proceedings and 264 civil proceedings, prevailing in the great majority of the enforcement actions decided by district courts or administrative law judges. In FY 2004, more than \$3 billion, a record amount in penalties and disgorgement, was ordered in cases brought by the SEC. Criminal proceedings were brought against 302 entities and individuals in matters relating to SEC cases in FY 2004.

New Performance Measure: Enforcement Cases Successfully Resolved

Description: Once the SEC determines through an enforcement investigation that a person or company has violated the law and should be charged, the SEC works to secure a judgment against the violator and appropriate sanctions. These cases are filed either in U.S. District Court or before an administrative law judge. Successfully resolved is defined as those parties against whom the SEC successfully obtained an administrative order or a judgment by consent, by default, through summary judgment, or following a bench or jury trial. This performance measure identifies the percentage successfully resolved in FY 2004 of all parties against whom a judgment was entered that year.



Analysis of Results: In FY 2004, the SEC successfully resolved the cases against the vast majority of the defendants or respondents it charged. In general, the SEC strives to bring cases that are as strong as possible but, at the same time, aims to file large, difficult, or precedent-setting cases when appropriate, even if success is not assured.

An Agency That Operates Effectively

A new risk assessment program aims to identify potential problems before investors are harmed.

Since Chairman Donaldson was appointed, he has focused on improving the SEC's ability to anticipate potential problems across the securities industry by "looking over the hills and around the corners" for the next emerging abuse of securities laws.

The Chairman initiated a thorough internal review of how the SEC identifies current problems and, equally important, future risks. As a result of this review, the SEC launched a new risk assessment program and created an Office of Risk Assessment, the first of its kind at the Commission.

The goal of the SEC's risk assessment program is twofold: to become better equipped to anticipate potential problems; and then to prevent these problems from affecting the markets. Toward these ends, the SEC first launched risk assessment activities within its various divisions and offices, creating internal risk teams that



Seated: **LeMont F. Neal**, Branch Chief in the Office of Human Resources' Pay, Employee Benefits and Special Projects Branch, has been with the SEC for five years. Mr. Neal has managed the implementation of a major automated position classification and staffing system, and helped to improve and expand electronic delivery of benefits information to SEC employees.

Standing: **Lewis Walker**, Assistant Director for Application Development in the Office of Information Technology, has six years of experience with the SEC. Mr. Walker is leading an effort to design the framework for the strategic application architecture to deliver the SEC's electronic workplace.

The SEC completed comprehensive workforce and workflow reviews of all SEC divisions and offices, leading to more efficient organizational structures and an improved alignment of the SEC's resources, needs, and mission priorities.

employed a “bottom-up” approach to mapping risk within each program. For those areas of greatest concern, the SEC proactively initiated risk-targeted examination sweeps, enforcement investigations, and disclosure reviews. Such efforts have helped focus the SEC's operations on those areas that present the biggest risks to investors. In addition, the recently hired Director of the Office of Risk Assessment will coordinate internal risk teams and help the entire Commission anticipate new or resurgent forms of fraud and questionable activities.

The SEC completed comprehensive workforce and workflow reviews of all SEC divisions and offices, leading to more efficient organizational structures and an improved alignment of the SEC's resources, needs, and mission priorities. These reviews helped ensure that all resources were allocated efficiently on the basis of well-defined program objectives so that the Commission has “the right people in the right place at the right time.”

Chairman Donaldson also launched the “dashboards” initiative to regularly track divisions' and offices' progress in achieving programmatic, operational, staffing, and budgetary objectives. These management reports help the Chairman and senior managers gauge performance and adjust operations and resources, as necessary.

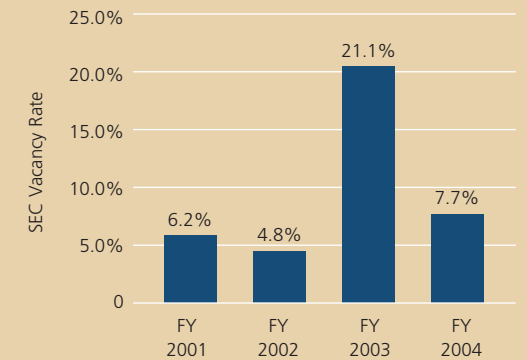
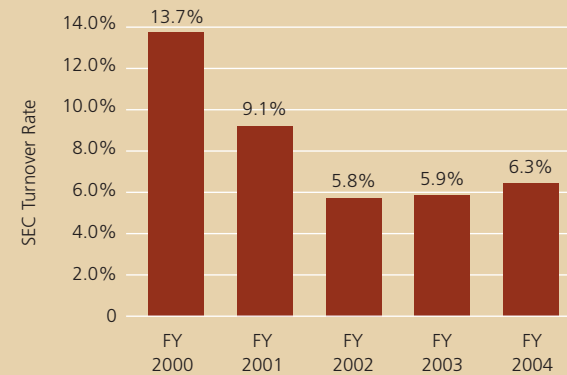
The Commission received authority from Congress to hire more than 840 new staff in February 2003, and in July 2003 the SEC was allowed to expedite the hiring of accountants, economists, and examiners. These two actions set the stage for a tremendous hiring wave in FY 2004. With the help of a significantly enhanced recruitment and orientation program, and without compromising quality, the SEC hired more than 1,000 new employees between FY 2002 and FY 2004, reducing its vacancy rate substantially. As the Commission continues to fill normally occurring vacancies, it will continue to explore innovative ways to attract top talent from diverse backgrounds, particularly accountants.

The SEC also continued to develop several important programs to retain employees with valuable skills. For example, the SEC continued its compensation program that rewards superior performance through a new pay-for-performance

Performance Measure:

SEC Turnover and Vacancy Rates

Description: Most of the functions performed by the SEC require highly trained staff to perform duties such as investigating violations of the federal securities laws, reviewing the activities or disclosures of securities market participants, or drafting new securities regulations. Therefore, the SEC has focused its energies on retaining high-performing staff and closely tracked its turnover rate to gauge the success of these efforts. Also, in FY 2003 Congress increased the SEC's size by more than 840 new staff positions. Therefore, a major goal for the SEC in FY 2004 was to fill these new positions and reduce the vacancy rate back to previous levels.



system. The Commission also offered an expanded benefits package that includes a number of programs, including: the student loan repayment program, which in FY 2004 covered about ten percent of the SEC's workforce; offering dental and vision benefits; maintaining life cycle accounts to help employees address work-life issues; and continuing its childcare subsidy program. The Commission also continued its commitment to staff training through the creation of the SEC University (SEC-U). These efforts have already begun to yield results. The GAO surveyed SEC staff and found them “significantly more satisfied with their pay and their ability to use flexitime and flexiplace.” In addition, the SEC's turnover rate has remained at historically low levels, although it has increased slightly in the past two fiscal years.

Separately, in addition to hiring a Director of Risk Assessment, the Chairman also rounded out the SEC's senior management team by hiring a new Chief Accountant, Chief Economist, and Chief Information Officer (CIO).

The SEC also executed an aggressive 20-month effort to prepare its first audited financial statements and Performance and Accountability Report. The SEC began reporting quarterly financial results in FY 2004 and worked diligently to strengthen its financial and internal controls.

Analysis of Results: In the late 1990s and early 2000s, the SEC experienced high turnover rates, mainly due to the availability of higher pay and benefits at other federal financial regulators and in the private sector. In FY 2001, the SEC gained the authority to set pay and benefits commensurate with other financial regulators within the federal government. Since that time, the Commission has implemented a pay-for-performance system, enhanced benefits, invested in new work-life programs, and bolstered its training programs through the SEC-U in an effort to reduce turnover. These efforts contributed to substantially lower turnover rates in the past few years. With respect to vacancies, the chart shows that the SEC had a high vacancy rate at the end of FY 2003, largely because it had not yet filled many of the more than 840 new positions that Congress approved for the SEC that year. The SEC has since launched a variety of new recruiting initiatives, significantly expanding its outreach, hiring two executive recruiting firms, and creating a new recruiting video. The SEC has lowered its vacancy rates substantially and also has about 100 additional staff hired and set to come on board early in FY 2005, which will reduce vacancies further.

In FY 2004, the Office of Information Technology implemented the initial stages of a comprehensive redesign of its capital planning and investment control processes.

Finally, the Office of Information Technology implemented an aggressive agenda under the SEC's new CIO. A few highlights of the many initiatives launched in FY 2004 are listed below:

- As part of its "data tagging" initiative, the SEC automated Forms 3, 4, and 5 using eXtensible Markup Language (XML) tagging formats, which permit filings over the web and enable SEC and public users to obtain data in a format useful for analysis.
- The Office of Information Technology continued to implement a document imaging and management system for the SEC. The initial stages of the effort focused on imaging the Division of Enforcement's large backlog of paper-based discovery documents. Concurrently, the Office of Information Technology upgraded many elements of the SEC's information technology (IT) infrastructure enabling it to handle the large-scale storage and retrieval of image files. This system will save staff time spent searching and analyzing millions of pages of documents, and protect this information in the event of an emergency that would damage paper documents.
- The point-to-point network redesign initiated in FY 2003 was made fully operational by the middle of FY 2004, providing continuous communications between SEC sites in the event that a disaster forces headquarters or the operations center to close.
- In FY 2004, the Office of Information Technology implemented the initial stages of a comprehensive redesign of its capital planning and investment control (CPIC) processes. The initial changes focused on new operating budget approvals and investment approval thresholds, which went into effect in early FY 2005.
- The SEC's enterprise architecture (EA) planning improved substantially in FY 2004, with the finalization of the EA repository and an internal website to provide EA information to all SEC staff. As a result, all project sponsors and managers are able to access the SEC's business reference model, information resource catalog, and other core elements of the SEC's EA in planning their projects.

New Performance Measure:

Milestones Achieved for High-Priority IT Projects

Description: The SEC focused its IT investments on five primary areas to enhance program effectiveness and operational efficiencies. A variety of projects have been implemented in these areas, ranging in complexity and duration (e.g., some may be completed in a single fiscal year while others span multiple fiscal years). This performance measure identifies some of the SEC's major IT initiatives and whether the SEC successfully achieved major project milestones.

	FY 2004 PLAN	FY 2004 ACTION TAKEN
EDGAR/Disclosure <i>The EDGAR (Electronic Data Gathering Analysis and Retrieval) system is operated by the Commission and allows for electronic submission, analysis, and dissemination of virtually all filings with the Commission.</i>	<ul style="list-style-type: none"> a. Electronically enhance Form 8-K b. Modify EDGAR to electronically accept Forms 3, 4, and 5 using XML c. Identify the elements of forms in anticipation of using a mark-up language d. Implement voluntary program to accept tagged financial data in filings 	<ul style="list-style-type: none"> a. Completed b. Completed c. Completed d. Initiated
Enforcement/Examination Activities	<ul style="list-style-type: none"> a. Image backlog of paper-based discovery documents b. Conduct a pilot to better handle electronic media evidence c. Provide fully automated processing of equity and options trade records in support of enforcement investigations 	<ul style="list-style-type: none"> a. In Progress b. Completed c. Completed (equity); Initiated (options)
Internal Productivity	<ul style="list-style-type: none"> a. Replace desktop, laptop, and monitor infrastructure to help employees work more productively inside and outside of the office b. Deploy a new generation of personal digital assistants to critical staff c. Upgrade the Freedom of Information Act system 	<ul style="list-style-type: none"> a. Completed b. Completed c. Completed
Security/Disaster Recovery	<ul style="list-style-type: none"> a. Expand agency-wide network capacity and implement point-to-point design for improved resiliency b. Migrate to an alternate data center outside of downtown Washington D.C. 	<ul style="list-style-type: none"> a. Completed b. In Progress
Electronic Government (e-Gov)/EA and CPIC	<ul style="list-style-type: none"> a. Redesign the CPIC processes b. Implement version one of the SEC's EA program 	<ul style="list-style-type: none"> a. Completed b. Completed

Analysis of Results: The SEC made significant progress in each of the major areas identified above. In particular, efforts such as the introduction of "tagged data" into EDGAR, document imaging, the implementation of the point-to-point system design, and progress on developing the Commission's EA will have major impacts on the efficiency and effectiveness of the SEC's programs. The SEC has formulated plans to build on these initiatives in FY 2005 through efforts such as developing the Commission's data mining and forensics applications, electronic media capture and search capabilities, and disclosure-related systems.



Challenges

Although the SEC successfully implemented an ambitious agenda in FY 2004, many challenges remain. Over the next year, the SEC anticipates taking action to address these challenges, through initiatives outlined in its five-year strategic plan. These initiatives will provide important protections for investors, improve the markets' structure, and enhance the SEC's operational effectiveness. The following are some of the SEC's key challenges, and the ways, both past and future, that the Commission has worked to address them.

Uncovering Emerging Threats to Investors. The SEC faces the continuing challenge of addressing new or resurgent forms of fraud and questionable activities before they pose a serious threat to investors. In FY 2004, the Commission began implementing an aggressive strategy to uncover emerging risks in their early stages through the risk assessment initiative launched by Chairman Donaldson. The SEC will expand upon this effort in FY 2005, hiring additional staff dedicated to risk management and developing new techniques to detect, gauge, and manage sources of potential risk, whether in disclosure filings, market data, evidentiary or examination documents, or elsewhere. New technologies may include diagnostic and data mining systems, collaborative software,

or access to new databases. For example, within the examination program, the SEC will launch a surveillance system for funds and advisers. The system will provide current information about funds and their advisers, so that the Office of Compliance Inspections and Examinations can identify trends and patterns that require follow-up by examiners or other staff. The Office of Compliance Inspections and Examinations also will begin implementing a new initiative to deploy monitoring teams for the largest investment advisory organizations, which will serve as the SEC's "eyes and ears" for this critical industry.

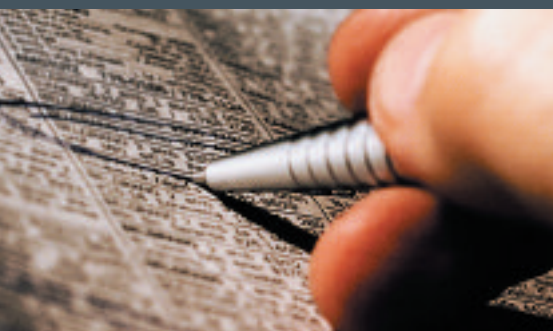
Analyzing Unprecedented Amounts of Data from Investigations and Examinations. The increasing complexity and technological sophistication of the securities markets has deeply affected the SEC's enforcement and examination programs, as the volume of data that might be relevant to an SEC investigation or inspection has grown exponentially. The SEC must adapt accordingly, with new systems and processes that can help staff review huge amounts of information quickly and thoroughly. In FY 2005, the SEC plans to upgrade the enforcement program's IT forensics capabilities, allowing staff to obtain and analyze data more quickly in the course of enforcement investigations. The SEC also will deploy new tools to analyze e-mail and other electronic media received through investigations and examinations for any contextual relationships. The imaging project initiated in FY 2004 will continue, completing the remainder of the enforcement program's paper document backlog and ensuring that the vast majority of enforcement document reviews can leverage automated search and browsing tools.

Enhancing Disclosures to Investors. Technological advancements have given the SEC an unprecedented opportunity to make disclosures more easily accessible and usable by the investor community. To meet this challenge, the SEC will move forward with its initiative to deploy "data tagging" to make financial data easier to analyze across industries or funds. The Commission also will explore converting additional disclosure forms into "tagged" format, redesign the Internet portal for the EDGAR system, and rebid the EDGAR contract with an eye toward substantially improving the effectiveness and flexibility of the system.

The SEC must adapt with new systems and processes that can help staff review huge amounts of information quickly and thoroughly.



Over the next fiscal year, the SEC must take a variety of additional steps to ensure that it becomes the “employer of choice” within the federal government, attracting and retaining a highly talented and diverse workforce.



Attracting and Retaining Quality Staff. The SEC has worked hard to bring its attrition rate down to the historic lows of the past few years. However, as shown above, with the recent economic recovery, the SEC’s attrition rate is inching up again. Over the next fiscal year, the SEC must take a variety of additional steps to ensure that it becomes the “employer of choice” within the federal government, attracting and retaining a highly talented and diverse workforce. The SEC will continue to refine its compensation and benefits packages to ensure that they are competitive with those of other federal financial regulators. The Commission will enhance its training program through the SEC-U, offering courses covering areas such as continuing education for attorneys and accountants, securities industry training, and employee development and management. The SEC will work to create high-quality facilities that will improve staff morale and improve productivity. The SEC’s facilities in Washington, D.C., New York, and Boston will implement such enhancements in FY 2005. Another priority is for the SEC to create a “virtual workforce” and expand the use of telework to permit staff to work from home and maintain work-life balance.

Financial Management System Controls. The SEC is committed to the effective and efficient management of the resources that have been entrusted to the Commission. The Commission has already taken a series of steps toward this goal and will continue to tighten internal controls in FY 2005, including the following:

- The SEC worked to enhance its internal controls in the area of property management and accountability. New procedures were implemented to identify, track, and report in-house software development costs, but they have not yet been formally documented.
- In FY 2003 the SEC met its goal of replacing the disgorgement tracking system with an upgrade to its Case Activity Tracking System, for which the financial components of the system were added in FY 2003 and populated in FY 2003 and FY 2004. Also in FY 2004, the SEC continued to work on procedures to

ensure that all enforcement activities resulting in an assessment of penalties and disgorgement are properly documented and reported in a timely manner. In FY 2005, the enforcement and accounting staff will continue to work to ensure that the data meets the Commission’s financial reporting needs.

Information Resources Management. The SEC is working continually to strengthen its information resources management program, which has been identified by the Inspector General as one of the agency’s ongoing challenges. In FY 2004, the Commission’s new CIO significantly restructured the Office of Information Technology by establishing EA and project management offices. In addition, the initial stages of a comprehensive redesign of its CPIC processes were implemented, an EA repository was finalized, and an internal website to provide ready access to the SEC’s business reference model and information resources catalog was made available. Finally, the Commission produced an IT policy framework to align the Office of Information Technology’s operational controls and policies with the Clinger-Cohen Act and the Office of Management and Budget (OMB) guidance. These efforts will continue in FY 2005, as the SEC continues to redesign its CPIC process, implements new tools for tracking IT projects, and completes its EA plan.

The SEC continues to make progress in developing and implementing a mature information security program. In FY 2004, the Office of Information Technology certified eight major IT systems and began working on completing the accreditation documentation. Further, the SEC initiated development of plans to improve its incident response capability, provided IT security training to 4,200 SEC employees and contractors, and continued its specialized training program for technical staff. In FY 2005, the certification and accreditation of the SEC’s IT systems will continue, and the Office of Information Technology will conduct a comprehensive review of its security policies, procedures, and technical architecture to ensure compliance with the best practices in information security. Also, the Office of Information Technology will deploy a new generation of intrusion detection and monitoring tools for its IT systems and network.

The SEC is working continually to strengthen its information resources management program.



Management Controls and Compliance with Laws and Regulations

SEC management is responsible for the fair presentation of the principal financial statements in conformity with GAAP and the requirements of OMB Bulletin Number 01-09. 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.

Federal Managers' Financial Integrity Act

The Federal Managers' Financial Integrity Act of 1982 (FMFIA) requires agencies to annually evaluate their system of internal control and report to the President and Congress on whether it complies with the standards and objectives set forth in the Act. If noncompliant, an agency's report must identify the material weaknesses and the plans for correcting those weaknesses. FMFIA also requires a statement indicating whether the agency's accounting system conforms to the principles and standards of the Comptroller General of the United States.

On December 22, 2004, the Chairman provided qualified assurance that, taken as a whole, the SEC's system of controls for the fiscal year ended September 30, 2004, was adequate and effective and had achieved the intended objectives under Section 2 of FMFIA. This qualified assurance considered two material weaknesses, which are discussed below.

The Chairman also reported that the financial management systems were generally in conformance with the principles and standards developed by the Comptroller General and implemented through OMB Circular A-127. One instance of material nonconformance was identified and is described below.

While the SEC acknowledged weaknesses in its internal controls and financial management systems, it also emphasized its commitment to be effective and efficient in the management of the resources entrusted to the Commission. A discussion of the corrective actions taken and planned by the SEC to address these matters is also described in the following pages.

FMFIA Management Control Program and Review Process

In accordance with guidance issued by the Commission's Executive Director, 26 management control components conducted informal reviews of their financial, administrative, and program management controls. In addition, the SEC's Office of Inspector General completed 23 alternative reviews during FY 2004. Most components were reviewed, with some undergoing multiple reviews.





Further, the SEC's Executive Review Board, which is responsible for overseeing the use of the Commission's human resources, conducted a thorough assessment of the management responsibilities of all supervisors, managers, and senior officers. The review involved developing a framework that would ensure adequate supervision of staff and equitable distribution of responsibility and workload among supervisors and managers.

Finally, GAO conducted an audit of the SEC's financial statements. GAO's procedures included audits of the financial statements, the management controls over the financial systems and operating procedures affecting the statements, and the SEC's compliance with selected provisions of laws and regulations applicable to the management of financial resources.

Status of Management Controls

In December the SEC reported two material weaknesses under Section 2 of the FMFIA and one material nonconformance under Section 4. During the audit of SEC's financial statements, a third material weakness was identified related to the SEC's preparation of financial statements. The three material weaknesses and the material matter of nonconformance are outlined below.

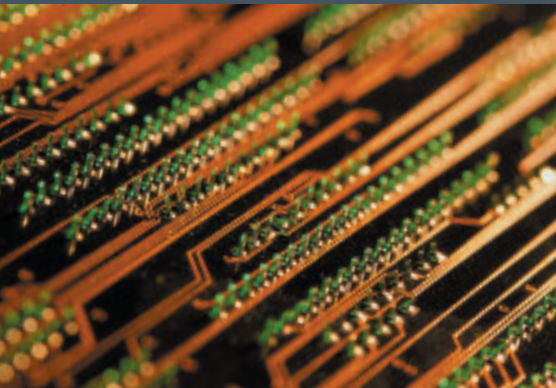
The internal control standards for Federal agencies established by the GAO defines a material weakness as a significant deficiency or deficiencies in the design or operation of one or more internal control components that fail to reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements would occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. OMB guidance defines nonconformance as "instances in which financial management systems do not substantially conform to financial systems requirements."

1. Penalties and Disgorgement

Description: The SEC has a material weakness related to its collection and management of financial information on penalties and disgorgement ordered as a result of SEC enforcement actions and one nonconformance related to federal financial management system requirements. These issues arise because the agency did not have a management information system in place to collect accurate data on penalties and disgorgement when the requirement for audited financial statements was set. The SEC needs to finish the development of comprehensive policies and implement internal controls for the system developed in the past two years to collect the needed financial data. To compensate for the system limitations, the SEC staff performed extensive manual procedures to compile necessary information and update the accounting system which the GAO then tested to obtain support for the estimated net amounts receivable. However, errors and inconsistent reporting were noted that confirmed a need for improved controls.

Corrective Actions Taken: Since the beginning of calendar year 2003, SEC staff identified data needed for financial reporting, designed and implemented a system to record and report on data collected, designated and trained reporting and reviewing staff, developed manuals and procedures, and entered data on over 12,000 parties to SEC enforcement actions. In the Chairman's December 2004 FMFIA report, management recognized the need to reexamine and change certain documentation and data entry procedures and to strengthen coordination and communication among offices. In addition, the report indicated that the new system for tracking and recording penalties and disgorgement requires further adaptations to strengthen data integrity support, and to assure effective internal controls exist to provide for accurate financial reporting on complex aspects of judicial and administrative orders.

Penalties and Disgorgement
Corrective Actions Planned: During FY 2005 the staff will complete a comprehensive review of files and data and review and strengthen policies and procedures. The enhanced procedures will strengthen internal control over the existing management information system. It is anticipated that consistent application of the internal controls and limited system redesign, to improve recording and reporting capabilities, will be adequate to resolve the material weakness in FY 2006. However, replacement of the current system will provide more effective assurance that internal controls are consistently applied. To that end, in FY 2005 the SEC also will begin a multi-year project to replace the existing system. A requirements analysis will be completed in FY 2006.



2. Information Systems and Security Controls

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 stem from the historical lack of a comprehensive agency program to manage information security; specifically, weaknesses have been identified in access control management, network security, audit and monitoring functions, user awareness, and other areas. Compliance with the requirements of OMB Circular A-130, Appendix III, regarding accreditation of applications and the Federal Information Security Management Act also requires strengthening.

The GAO audit confirmed many of the findings reported in prior years through the FMFIA and audit programs related to general controls over information technology security. While the auditors did not note any instances of security breaches that would affect the financial systems or records, they concluded that these information security control weaknesses put sensitive data—including payroll and financial transactions, personnel data, and other program-related information—at increased risk of unauthorized disclosure or modification. In addition, the SEC was found to lack a comprehensive monitoring program to identify unusual or suspicious activity. However, their review of existing controls and agency remediation plans provided adequate assurance that financial data and systems were auditable.

Corrective Actions Taken: The SEC has launched a series of initiatives to reorganize its information security program, and reorient it towards resolving the control issues outlined above. The Commission began its certification and accreditation efforts in FY 2003 to ensure that all major information systems are designed and operated with acceptable levels of security risk; this effort is ongoing. In FY 2004 the SEC hired a Chief Information Security Officer to centrally manage and implement the various components of its information security program. SEC staff also began revising information security control documents and all policies, procedures and guidelines to reflect National Institute of Standards and Technology guidelines as mandated by FISMA. The SEC continued to promulgate security awareness training internally—4,200 employees and contractors were trained in FY 2004—and implemented a specialized security training program for technical staff.

3. Preparation of Financial Statements

Description: The SEC produced its first complete set of financial statements in 2004. In preparing the financial statements, material errors were noted in the opening balances and procedures did not exist to support the process to accumulate the necessary data to complete the financial statements. As a result, the process to prepare the FY 2004 financial statements was manually intensive, consumed significant staff resources, and did not include documentation of quality control procedures. Additionally, comprehensive accounting policies and procedures for several major areas were still in draft or still needed to be developed.

Information Systems and Security Controls

Corrective Actions Planned: Both SEC general support systems and financial applications will be certified and accredited by the end of calendar year 2005. Corrective actions for the specific control weaknesses identified in the GAO review are being implemented according to a quarter-by-quarter timeline, and will be complete by June 2006. Meanwhile, the agency will continue to redesign and enhance its overall information security program by: (1) clarifying roles and responsibilities for enterprise information security, (2) developing and revising security risk assessment processes, (3) implementing a comprehensive set of information security policies and procedures, (4) providing security awareness training to employees and contractors, and (5) systematically testing policies and procedures for their appropriateness and effectiveness.

Preparation of Financial Statements

Corrective Actions Planned: During FY 2005, the SEC will increase its financial reporting staff and formalize policies and procedures used in the first year of financial reporting. The SEC will develop policies and procedures where they did not exist and preliminary accounting procedures still in draft will be finalized. Consistent application of the enhanced procedures for recording penalties and disgorgement also will increase assurance that significant balances are reported accurately.

Corrective Actions Taken: The SEC assigned financial reporting staff and developed procedures to compile and issue FY 2004 annual financial statements. The staff drafted and applied the accounting policies necessary to prepare the complete set of financial statements. The SEC has made all necessary accounting adjustments to correct the errors in the opening balances and, as a result of implementation of the new policies, does not expect errors of this nature to recur. The SEC is now developing a plan to review, update and document the preliminary accounting procedures established during FY 2004.

Efforts to solicit advice from staff experts within SEC will continue. In addition, this spring the SEC will establish a formal audit committee to provide regular review by key management officials of SEC financial reports and to provide advice to strengthen operations, policies and controls.

The Office of Management and Budget recently issued a revised Circular A-123 on Management's Responsibility for Internal Control. By the end of FY 2005 SEC will develop a plan for implementation, as the revisions will become effective for FY 2006.

Financial Management Systems

Although the SEC is not required to report under the Federal Financial Management Improvement Act, the Commission believes it is in substantial compliance with federal financial management system requirements, federal accounting standards, and the U.S. Government Standard General Ledger, except for the forgoing discussion on reporting under Section 4 of FMFIA.

Federal Information Security Management Act

FISMA requires federal agencies to conduct an annual self-assessment review of their IT security program, to develop and implement remediation efforts for identified security weaknesses and vulnerabilities, and to report compliance to OMB. SEC's Office of Inspector General performed an independent review of

SEC's compliance with FISMA requirements. The report confirmed the SEC had successfully eliminated a previously identified significant deficiency, however, during this review four additional significant deficiencies were noted. The SEC submitted its annual FISMA report to OMB in November 2004.

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 2004, the SEC did not pay interest penalties on 95.4 percent of the 13,487 vendor invoices processed, representing payments of approximately \$138.8 million. Of the invoices that were not processed in a timely manner, the SEC was required to pay interest penalties on 623 invoices, and was not required to pay interest penalties on 983 invoices, where the interest was calculated at less than \$1. In FY 2004, the SEC paid over \$90,000 in interest penalties, or \$649 in interest penalties for every million dollars of vendor payments.

Improper Payments Information Act

The Improper Payments Information Act requires federal agencies to annually review 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 2004, the SEC had controls in place to identify and correct erroneous payments that, 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 2004, the SEC referred \$271.1 million to Treasury for collection. Collections of delinquent debt by Treasury for the same period was \$178,700.



Performance Measures Summary

The SEC's performance measurement systems have been significantly enhanced by two major efforts in FY 2004. First, the Commission approved a new five-year strategic plan that sets the direction for the SEC with a new vision, mission, values, and goals. The SEC also launched the "dashboards" initiative to enhance its performance measures and provide senior managers with regular snapshots of the agency's progress toward its goals. As a result of these efforts, many of the measures listed on the opposite page are new, and some do not yet show data for FY 2004 or previous years.

These performance measures gauge how much activity the Commission conducts in a given fiscal year, how quickly it accomplishes its tasks, and what effects these activities have on the markets and for investors. However, for the SEC, measuring outcomes is the most challenging area of the three, as is the case with many regulatory and law enforcement agencies. In many instances, the Commission's impact can only be assessed indirectly. The SEC has devised a number of proxy measures that, when taken as a whole, provide a reasonable picture of its effectiveness in fulfilling its mission. As the Commission learns from its experience in this area, it will continue to refine these measures, both in the "dashboards" and in future performance reports. A summary of the SEC's major performance measures, organized by goal, is presented in the following table.

Performance Results Summary

GOAL 1: ENFORCE COMPLIANCE WITH THE FEDERAL SECURITIES LAWS	FY 2004 PERFORMANCE
1. Significant deficiencies detected and referrals to the Division of Enforcement from:	
a. Examination Staff	+
b. Division of Corporation Finance	+
2. Enforcement cases successfully resolved.	+
3. Number of investment advisers and investment companies examined.	✓
4. Number of requests to and by foreign regulators for enforcement assistance.	✓
5. Percentage of first enforcement cases filed within two years.	+
6. Monetary penalties and disgorgement ordered and the amounts and percentage collected by the SEC:	
a. Ordered	+
b. Collected	+
7. Distribution of cases across core enforcement areas.	✓
GOAL 2: SUSTAIN AN EFFECTIVE AND FLEXIBLE REGULATORY ENVIRONMENT	FY 2004 PERFORMANCE
1. Milestones achieved for high-priority rulemakings.	✓
2. Percentage of households owning mutual funds.	✓
3. Global access to U.S. markets:	
a. Number of new foreign private issuers	-
b. Dollar value of securities registered by foreign private issues	+
4. Percentage of SRO rule filings closed within 60 days.	+
5. Percentage of responses to exemptive, no-action letters, and interpretive requests issued within six months.	+
GOAL 3: ENCOURAGE AND PROMOTE INFORMED INVESTMENT DECISIONMAKING	FY 2004 PERFORMANCE
1. Disclosure filings reviewed by SEC:	
a. Corporations with disclosures	-
b. Investment companies with disclosures	+
2. 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.	n/a
3. Percentage of investment company reviews completed within timeliness goals.	+
4. Average time to issue initial comments on Securities Act filings.	✓
5. Number of online searches for EDGAR filings.	+
6. Percentage of forms and submissions filed electronically and in structured formats.	n/a
7. Number and percentage of investor complaints, questions, and requests completed by the Office of Investor Education and Assistance within seven calendar days.	✓
8. Investor education publications distributed by the General Services Administration.	+
GOAL 4: MAXIMIZE THE USE OF SEC RESOURCES	FY 2004 PERFORMANCE
1. SEC turnover and vacancy rates:	
a. Turnover rate	✓
b. Vacancy rate	+
2. Milestones achieved on major IT projects.	✓
3. Milestones achieved on major human capital initiatives.	✓
4. Milestones achieved on major facilities projects.	✓
5. Receive an unqualified audit opinion on the SEC's audited financial statements with no material weaknesses noted on the Commission's internal controls:	
a. Audit opinion	✓
b. Material weaknesses	-
6. Percentage of IT projects that conform to the SEC's CPIC process.	✓

Level of Performance Attained

- + Exceeded Target or Prior Year's Performance Level
- ✓ Achieved Target or Maintained Prior Year's Performance Level
- Less Than Target or Prior Year's Performance Level
- n/a Data Not Available

Financial Highlights

The SEC's financial statements summarize its financial activity and financial position. The SEC prepared audited financial statements for the first time in FY 2004 pursuant to the mandate of the Accountability of Tax Dollars Act of 2002. The statements were audited by the GAO and received an unqualified opinion. The audit also addressed the SEC's internal controls and compliance with federal laws and regulations that have a direct effect on the financial statements.

Net Position

The major components of the SEC's financial activities consist of Fund Balance With Treasury (FBWT), Accounts Receivable, Property and Equipment, Liabilities, and Revenues and Costs. A brief discussion of each of these components is presented below.

Composition of SEC's Assets, Liabilities, and Net Position as of September 30, 2004

(Dollars in Thousands)

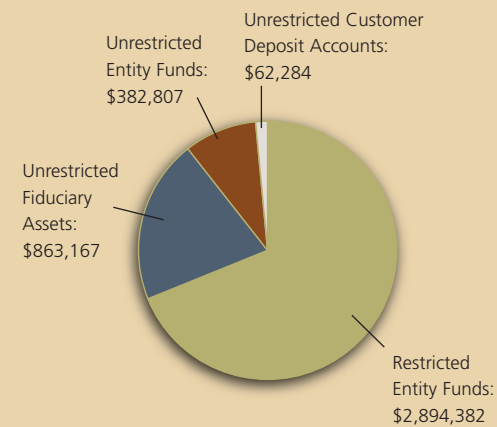
	2004	PERCENT
Cash	\$ 11	—
Fund Balance With Treasury	4,202,640	91.80
Accounts Receivable (Net)	326,502	7.13
Property and Equipment (Net)	49,103	1.07
Prepayments	11	—
Total Assets	\$4,578,267	100.00
Fiduciary Liability	\$ 863,167	67.03
Custodial Liability	279,054	21.67
Customer Deposit Accounts	62,284	4.84
Accrued Payroll, Leave, and Benefits	52,334	4.06
Accounts Payable	24,511	1.90
Other Liabilities	5,816	0.46
Commitments and Contingencies	500	0.04
Total Liabilities	\$1,287,666	100.00
Cumulative Results of Operations	\$3,290,288	99.99
Unexpended Appropriations	313	.01
Net Position	\$3,290,601	100.00
Total Liabilities and Net Position	\$4,578,267	100.00

Fund Balance With Treasury

As of September 30, 2004, the SEC's FBWT of \$4,202.6 million represents 91.80 percent of assets totaling \$4,578.3 million. As summarized in the chart on the following page, FBWT includes (1) restricted entity funds that represent funds not available for use by the SEC and can only be made available by the U.S. Congress; (2) unrestricted fiduciary assets, which include the collection of civil monetary penalties, interest, and disgorged ill-gotten gains that may be paid out to harmed investors pursuant

Fund Balance With Treasury as of September 30, 2004

(Dollars in Thousands)



to authorized distribution plans; (3) unrestricted entity funds that are obligated and unobligated balances available to finance expenditures; and (4) unrestricted customer deposit accounts for customers who maintain a deposit account at the SEC to facilitate filing processes.

Restricted funds are the bulk of the SEC's FBWT and are primarily an accumulation of fees and assessments paid to the Commission since 1991 pursuant to Section 6(b) of the Securities Act of 1933 and Sections 13(e), 14 (g), and 31 of the Securities Exchange Act of 1934 in excess of amounts that the SEC was authorized to use in its annual operations through the Congressional appropriations process. The SEC does not have authority to spend these funds unless it obtains permission through legislation from Congress.

Given the restricted nature of these fees, SEC management has begun exploring ways for a permanent resolution that would allow the SEC to exclude these funds from its assets. SEC management is also undertaking a multi-year legislative effort to bring the amount of fees generated by the SEC in line with its annual operating budget and eliminate surplus fees.

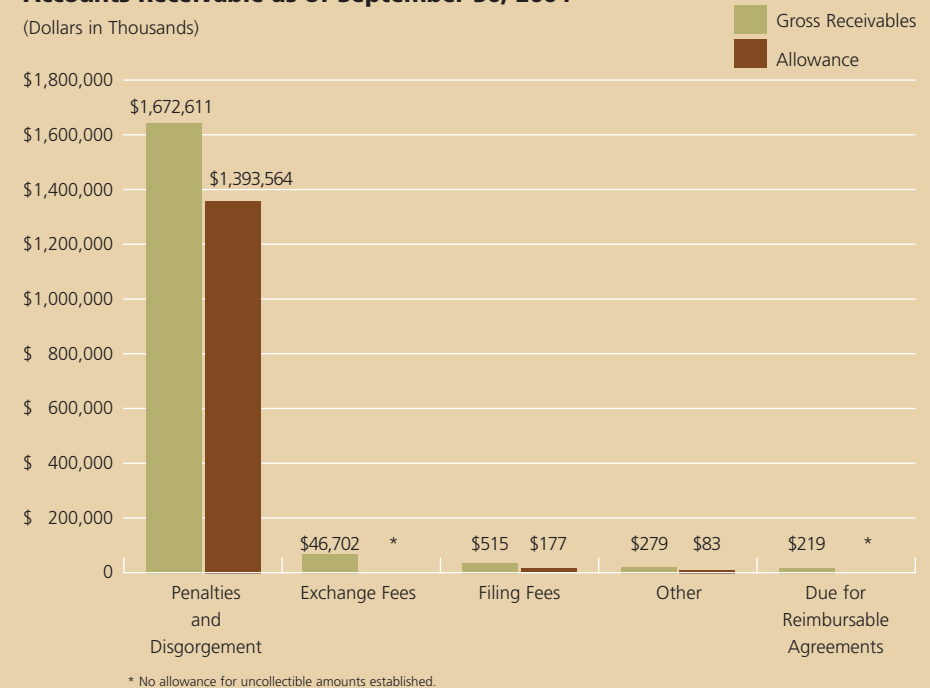
Accounts Receivable

The SEC's net accounts receivable as of September 30, 2004, of \$326.5 million consists of gross accounts receivable and an estimated allowance for uncollectible amounts of \$1,720.3 million and \$1,393.8 million, respectively.

Civil monetary penalties levied against violators of federal securities laws constitute most of the SEC's accounts receivable activity. The SEC has a fiduciary responsibility to collect, manage, and distribute civil monetary penalties and disgorgement to non-federal individuals or entities pursuant to plans approved by the court or Commission. These fiduciary receipts constitute the SEC's collection, management, and disposition of cash or other assets in which non-federal individuals or entities have an ownership interest that the SEC must uphold. When collected, fiduciary receipts are included in FBWT, and an equal and offsetting liability for assets held by the SEC at or outside of the U.S. Department of the Treasury (Treasury) is reported in the name of the SEC as a

Accounts Receivable as of September 30, 2004

(Dollars in Thousands)



non-entity liability in the Balance Sheet. The SEC has a custodial responsibility over non-entity accounts receivable, which are established when the SEC has been designated in administrative proceedings or court-ordered judgments to collect, manage, or distribute the assessed disgorgement, penalties, and interest. When collected, these funds are returned to the General Fund of the Treasury. The SEC is not authorized to use the funds.

The SEC's allowance for doubtful accounts is an estimate of how much of the gross accounts receivable are uncollectible. The overall allowance of 81.02 percent is based on an analysis of certain large individual accounts and historical collection activity.

Property and Equipment

The SEC's property and equipment consists of software and general purpose equipment, capital improvements made to buildings that the SEC leases for office space, and internal-use

Cost of Property and Equipment as of September 30, 2004

(Dollars in Thousands)

	2004	PERCENT
Equipment	\$23,939	29.24
Software	36,591	44.68
Software-in-Progress	3,758	4.59
Leasehold Improvements	17,600	21.49
Total Property and Equipment	\$81,888	100.00

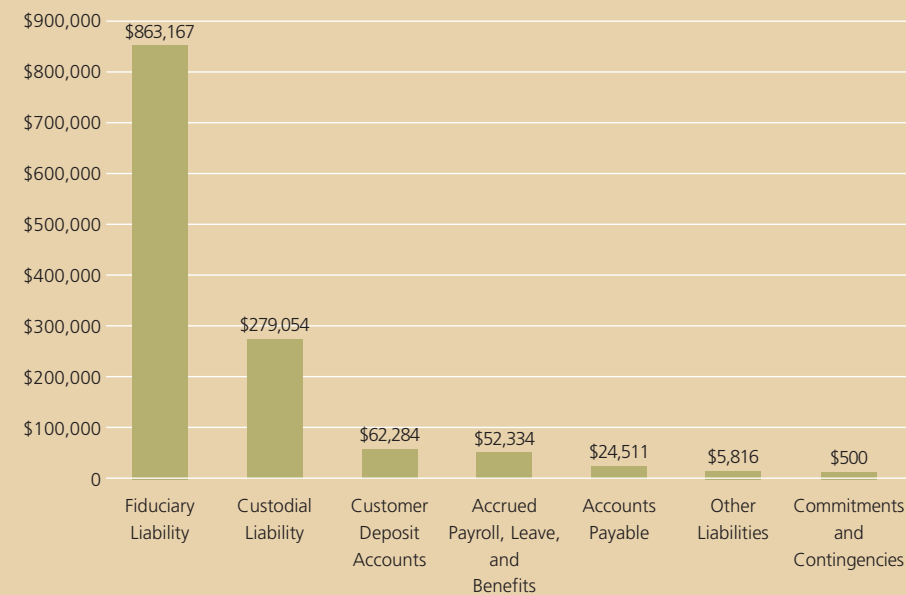
software development costs for projects in development. The cost of the SEC's property and equipment as of September 30, 2004, is summarized in the table above.

Liabilities

A summary of the SEC's liabilities as of September 30, 2004, is presented below.

Liabilities as of September 30, 2004

(Dollars in Thousands)



Most of the SEC's liabilities are the result of its fiduciary and custodial liabilities. Fiduciary activities consist of the receipt, management, accounting, and disposition by the SEC of cash or other assets in which non-federal individuals or entities may have an interest that the SEC or federal government must uphold. The SEC's fiduciary liabilities arise out of cases brought by the SEC against respondents. This monetary relief can take the form of civil monetary penalties or disgorged ill-gotten gains. In administrative proceedings, assessed civil monetary penalties may be added to disgorged illegal gains and become part of the disgorgement fund that the SEC maintains for distribution to the victims of the violations. The fund balances result from fiduciary activities undertaken pursuant to the SEC's statutory direction and authority.

The SEC's custodial liability as reported on the Statement of Custodial Activity consists primarily of disgorgement, penalties, and interest paid by violators of federal securities laws into the General Fund of the Treasury. Non-federal individuals or entities do not have an ownership interest in these moneys, and the SEC is not authorized by law to use the funds.

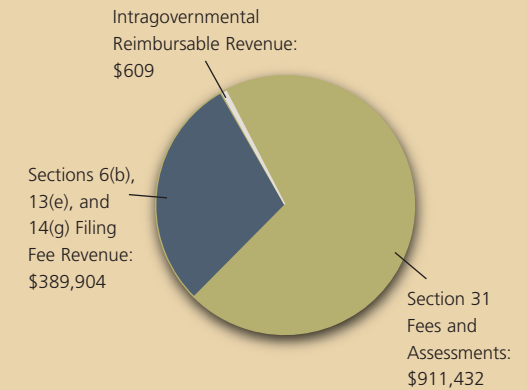
Revenues and Costs

The SEC's \$575.8 million net income from operations is a result of gross revenues and cost of operations in the amounts of \$1,301.9 million and \$726.1 million, respectively. The SEC's revenues represent fees and assessments paid pursuant to Section 6(b) of the Securities Act of 1933 and Sections 13(e), 14 (g), and 31 of the Securities Exchange Act of 1934.

These fees and assessments support the SEC's six major program areas, including Full Disclosure, Prevention and Suppression of Fraud, Supervision and Regulation of Securities Markets, Investment Management Regulation, Legal and Economic Services, and Program Direction. The gross cost of operations for these six program areas is presented at right. SEC management plans to explore reorganizing the structure of its programs in FY 2005.

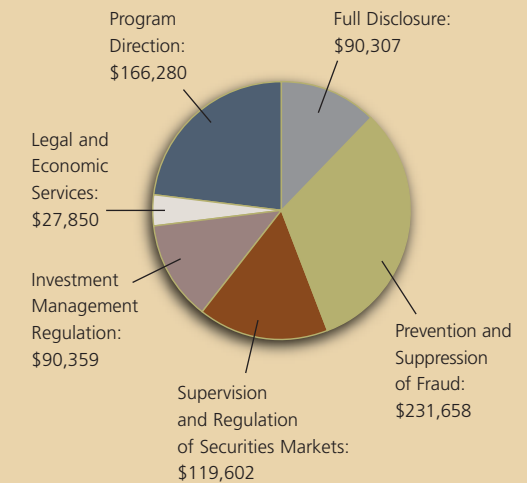
Revenue Summary for the Year Ended September 30, 2004

(Dollars in Thousands)



Gross Cost of Operations for the Year Ended September 30, 2004

(Dollars in Thousands)



Headquarters Offices

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Managing Executive for External Affairs

Vacant
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Managing Executive for Policy

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Division of Market Regulation

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Office of Legislative Affairs

Jane O. Cobb, Director
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Office of Public Affairs

Matthew Well, Director
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Office of Risk Assessment

Charles Fishkin, Director
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Office of the Secretary

Jonathan G. Katz, Secretary
(202) 942-7070

Regional and District Offices

Region 1

Northeast Regional Office

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Regional Director
3 World Financial Center
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(212) 336-1100

Region: Connecticut, Delaware,
District of Columbia, Maine,
Maryland, Massachusetts,
New Hampshire, New Jersey,
New York, Pennsylvania,
Rhode Island, Vermont, Virginia,
and West Virginia

Boston District Office

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District Administrator
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Philadelphia District Office

Arthur S. Gabinet,
District Administrator
The Mellon Independence Center
701 Market Street
Philadelphia, PA 19106-1532
(215) 597-3100
TTY (215) 597-0687

Region 2

Southeast Regional Office

David Nelson,
Regional Director
801 Brickell Ave., Suite 1800
Miami, FL 33131
(305) 982-6300

Region: Alabama, Florida,
Georgia, Louisiana, Mississippi,
North Carolina, Puerto Rico,
South Carolina, Tennessee,
and Virgin Islands

Atlanta District Office

Richard P. Wessel,
District Administrator
3475 Lenox Road, N.E.
Suite 1000
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(404) 842-7600
TTY (404) 842-7676

Region 3

Midwest Regional Office

175 W. Jackson Boulevard
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TTY (312) 886-6256

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Kentucky, Michigan, Minnesota,
Missouri, Ohio, and Wisconsin

Region 4

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Region: Arkansas, Colorado,
Kansas, Nebraska, New Mexico,
North Dakota, Oklahoma,
South Dakota, Texas, Utah,
and Wyoming

Fort Worth District Office

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District Administrator
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Salt Lake District Office

Kenneth D. Israel, Jr.,
District Administrator
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Pacific Regional Office

Randall R. Lee,
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TTY (323) 525-3631

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Idaho, Montana, Nevada,
Oregon, and Washington

San Francisco District Office

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