S. HRG. 110–927

THE STATE OF THE SECURITIES MARKETS

HEARING

BEFORE THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

ON

EXAMINING CURRENT ISSUES AND MATTERS RAISED IN PREVIOUS SECURITIES HEARINGS

TUESDAY, JULY 31, 2007

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: http://www.access.gpo.gov/congress/senate/senate05sh.html

U.S. GOVERNMENT PRINTING OFFICE

50–353 WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

CHRISTOPHER J. DODD, Connecticut, *Chairman*

TIM JOHNSON, South Dakota
JACK REED, Rhode Island
CHARLES E. SCHUMER, New York
EVAN BAYH, Indiana
THOMAS R. CARPER, Delaware
ROBERT MENENDEZ, New Jersey
DANIEL K. AKAKA, Hawaii
SHERROD BROWN, Ohio
ROBERT P. CASEY, Pennsylvania
JON TESTER, Montana

RICHARD C. SHELBY, Alabama
ROBERT F. BENNETT, Utah
WAYNE ALLARD, Colorado
MICHAEL B. ENZI, Wyoming
CHUCK HAGEL, Nebraska
JIM BUNNING, Kentucky
MIKE CRAPO, Idaho
JOHN E. SUNUNU, New Hampshire
ELIZABETH DOLE, North Carolina
MEL MARTINEZ, Florida

SHAWN MAHER, *Staff Director*
WILLIAM D. DUHNKE, *Republican Staff Director and Counsel*
DEAN V. SHAHINIAN, *Counsel*
JUSTIN DALY, *Republican Counsel*
JOSEPH R. KOLINSKI, *Chief Clerk and Computer Systems Administrator*
JIM CROWELL, *Editor*

C O N T E N T S

TUESDAY, JULY 31, 2007

WITNESSES

THE STATE OF THE SECURITIES MARKETS

TUESDAY, JULY 31, 2007

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 9:48 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order.

This morning we are going to hold an oversight hearing on the state of the securities markets. We are pleased to have as our witness Chairman Christopher Cox. Mr. Chairman, we welcome you to the Committee.

The securities markets of course, as we all know, are a significant area of the Banking Committee's jurisdiction and raise a broad range of issues. This Committee has a long history of vigorous oversight of these markets and their regulators, a practice that I fully intend to continue as Chairman of the Committee.

In my view, this Committee has two primary objectives with regard to the securities markets. One is to promote the efficient and effective operation of these markets so that they can enable individuals to invest and businesses to raise capital, and second to protect each and every investor from large institutional investors to small retail investors and ensure that they are treated fairly and openly by the market participants with which their investments are entrusted.

The U.S. securities markets are the most efficient, liquid, and transparent in the world. Retail and institutional investors, hedge funds, private equity, public corporations, underwriters, brokers, exchanges and other participants are prospering, notwithstanding the market's performance late last week. These markets are key contributors to the health of the economy and to the welfare of our Nation.

Therefore, I believe it is critical that the Federal and State securities regulators fulfill their statutory missions to protect investors and promote fair and efficient markets. The Securities and Exchange Commission's ongoing effectiveness promotes confidence and is a key to the future success of the markets.

In this context, the Committee oversees a number of securities issues. A more complete list of areas of particular significance is contained in my formal remarks which are part of the record. However, in the interest of my colleagues' time, allow me to mention just three this morning, if I can, in my opening statement: the implementations of Sarbanes-Oxley, tax proposals affecting hedge funds, private equity firms and publicly traded partnerships, and the state of market regulation.

Regarding Sarbanes-Oxley, last week the Commission approved the Public Company Accounting Oversight Board's Auditing Standard Number 5 which more effectively directs the implementation of Section 404 of the Sarbanes-Oxley Act. I commend Chairman Cox and the PCAOB Chairman Mark Olson and their colleagues for the work that they have done on that matter. The SEC and the PCAOB responded thoughtfully to the concerns of industry, including smaller businesses, while guarding the legitimate interests of all investors with strong internal controls at their companies.

This new standard directs auditors to review those areas that present the highest risk and to conduct their work appropriate to the size and complexity of the company. It is expected to lower compliance cost and enable all public companies to comply more easily with the statutory requirement to have management and outside auditors attest to internal controls.

Public companies which have not yet begun to comply with this law, which was passed 5 years ago, should begin to do so now, in my view. American securities markets should not list companies that, in effect, abide by two different standards regarding their financial controls. Surveys of market participants, including CEOs of major corporations, conclude that Sarbanes-Oxley is sound in achieving its goals of improving financial reporting, strengthening corporate governance, and enhancing the integrity of analysts recommendations. The performance of the markets since Sarbanes-Oxley's enactment 5 years ago underscores the fact that this new law is strengthening our Nation's economy in my view.

I am also pleased that Sarbanes-Oxley created the Fair Fund through which the Commission has distributed billions of dollars to investors who are harmed through securities misconduct. This Committee will continue to monitor Sarbanes-Oxley and we invite ideas from both the private and public sectors to ways in which we can strengthen this law as we watch it unfold.

Regarding tax proposals affecting hedge funds, private equity funds, publicly traded partnerships and others, let me say that as Chairman of the Banking Committee I feel a strong responsibility to carefully examine legislative proposals emanating from any Committee which may have a significant impact on matters within this Committee's jurisdiction, particularly matters affecting the capital markets.

Recently legislation was introduced that would change the tax treatment of publicly traded partnerships and certain income called carried interest. I am concern about the potential adverse effects these proposals would have on capital formation and job creation and on institutional investors like pension funds and college endowments.

I have begun to hear arguments and analysis but I am not prepared to support any legislation before I have thoroughly analyzed the full impact it is likely to have on investors and markets. In this regard, Senator Shelby and I have written to Chairman Cox and to Secretary Paulson to ask their opinions of the impact such proposals would have on our markets and investors. I look forward to your insights on that matter, as well.

Again, that is not taking a position one way or another on this, but clearly it is in our interest in this Committee to have some idea what the implications could be of these tax proposals.

The third and final issue I would like to briefly mention is the state of market regulation. A core function of this Committee is overseeing market regulations. On July 26th the SEC approved the consolidation of the National Association of Securities Dealers and the New York Stock Exchange regulation into a single consolidated self-regulatory organization. It is incumbent upon the SEC to devote sufficient resources to effectively oversee the budget, governance, and operations of this new regulator.

It is critically important that as the North American Securities Administrators Association said, and I quote them "Harmonization does not compromise investor protection standards." Where the rules of the two organizations differ, we want to provide the strongest investor protection. The consolidation and regulation of securities exchanges is an international as well as a domestic challenge, given recent cross-border mergers.

Senator Reed, my colleague from Rhode Island, has chaired two superb hearings on these issues as Chairman of the Securities Subcommittee.

There are other important issues to be addressed that I will discuss in my state for the record. These include the regulation of investment fiduciaries and other professionals, disclosure and accounting in municipal securities markets, the partnership of the SEC and State securities regulators, the reposting of the SEC software tool to provide Internet links to SEC reports of companies disclosing business in countries that sponsor terrorism, shareholder proposals for access to the proxy including the important right to provide precatory proposals and many other issues.

You have provided important leadership, Mr. Chairman, I would say to you in these areas and others, and I know your full statement includes a number of comments on these matters which I have gone over and will have some questions for you regarding several of those comments you make in your statement.

I also want to commend you and the Commission for seeking to have an amicus brief with the Commission's historical view filed in the Stonebridge case. I am disappointed that the Solicitor General chose not to file the brief, depriving the Supreme Court of the Commission's views as it interprets the Federal securities laws.

Let me say, as well, regarding this matter here that I have been in touch with my colleagues in the House and it is my intention to try and file an amicus brief in that matter, as well. We are a little late in terms of whether or not they will receive it or not, and that is true of the House matter, as well. But I believe it is worth submitting an amicus brief and we will be prepared to do that.

I have not had a chance to talk with the Ranking Member about this, but if he wants to join me in that, and I will leave that up to him, at some point we may do it together.

But I commend the Commission for doing so and hopefully they will take your views into consideration.

I look forward to working with you, Mr. Chairman, and others on these issues that rise to promote efficient securities markets and to protect investors.

With that, let me turn to Ranking Member, Senator Shelby, for any opening comments.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you. Thank you, Mr. Chairman.

Today the Banking Committee, as you have explained, examines the current state of the securities markets. I would like to welcome Chairman Cox back to the Committee and I would also like to commend you, Chairman Cox, for your continued leadership at the Securities and Exchange Commission.

The SEC has been quite active this year and we have been monitoring its work with great interest. We will continue to do so.

The securities industry is undergoing rapid and dramatic changes for a number of reasons, none of which are probably more significant than increased global competition and advances in technology. For decades, the U.S. was the world's unchallenged financial center. Today, however, we must compete against numerous and increasingly sophisticated foreign markets. We cannot, I believe, reverse the tide of global competition or technological innovation, nor would we want to. We can and should, however, continually reassess and re-examine our approach to financial regulation in a constantly changing global environment.

Although improved regulation will not inoculate the U.S. from global competition, I believe it is important to recognize that a dynamic rather than static regulatory structure gives the U.S. the best chance to compete.

In the securities markets, regulation is necessary to protect investors, particularly retail investors, but it should be smart, balanced, and narrowly tailored to avoid as much as possible unintended consequences.

I believe we must be careful not to regulate for regulation's sake. Rather, we should intervene only when market forces are incapable of policing conduct. When the market fails, we should examine whether existing regulations are being enforced. If a new regulation is deemed necessary, we must weigh carefully the benefits with the costs.

The SEC's statutory duty to protect investors is well known but that duty, I believe, also extends to promoting efficiency, competition, and capital formation. This means that the benefits of any new regulation must outweigh its costs.

For example, last week the Commission adopted a new standard for auditors, applying Section 404 of Sarbanes-Oxley. While Section 404 has provided some benefits, the costs have been too high and the new standard is intended to lower the cost of implementing the internal controls provision. This is a very positive development, Chairman Cox, and I encourage the Commission to continue this type of cost-benefit analysis across the SEC's regulatory spectrum.

Chairman Cox, thank you for your appearance and thank you for your work at the SEC. I look forward to your testimony.

Chairman DODD. Let me ask my colleagues, Senator Menendez, do you have an opening statement?

STATEMENT OF SENATOR ROBERT MENENDEZ

Senator MENENDEZ. Thank you, Mr. Chairman.

Mr. Chairman, thank you for calling this hearing and I think it is incredibly important timing. I want to welcome Chairman Cox, as well.

Today entrance into the world of financial markets is open to anyone with extra capital who is willing to take a few risks in the hope of some promising returns. Roughly half of all U.S. households have some investments of some type, whether in mutual funds or individual stocks. So investors are no longer a singular class. Rather, they represent an increasingly diverse mix of Americans looking to add to their savings, save for the future, or build their personal wealth.

That means more Americans are exposed to the risks that come with investing. As anyone who has ever invested knows, a certain level of risk is a given. But that risk is taken with some knowledge of the framework, some assurance that everyone is playing by the same rules, and the trust that if someone breaks or bends the rule they will be prosecuted.

Often the role of the SEC is to provide some sense of security in the otherwise unpredictable world of financial markets. That security is integral to anyone involved in the investment market from investor, traders, brokers, and exchanges alike.

One of the greatest challenges for providing that security is in the gray areas where regulation is not clear, where jurisdiction overlaps, where the guidelines may be blurred. This is where we turn to the SEC for what the acceptable standard will be, what the boundaries are, and most of all for what the rules of the game will be.

There will always be winners and losers but the real question is whether they are winning or losing fairly. As investment vehicles that elude direct regulation, such as hedge funds, become more prevalent the issue of fairness becomes even more pronounced. Just as we see examples of how the market is working, we have all seen stories of investors who lose it all at the hands of unscrupulous players.

As the hedge fund market continues to catch fire and more investors venture into an unregulated market, I think we have to carefully examine the protections that are in place and if they are sufficient. This is obviously an area the SEC has been looking carefully at and one I hope that they will continue to scrutinize.

I have a series of questions when we get to that part, Mr. Chairman, on investor protection and I look forward to our witness' response.

Chairman DODD. Thank you, Senator, very much.

Senator Sununu.

STATEMENT OF SENATOR JOHN E. SUNUNU

Senator SUNUNU. Thank you, Mr. Chairman.

I looked at this long line of Republicans and I did not think I would get an opportunity to provide an opening statement. I do not have an opening statement. But I know when we get to the questioning I may not be here.

Chairman Cox, I want to raise one issue that you might address. I do not think it is in your testimony but in some of the question and answers regarding market regulation and oversight I hope you will address the issue of market data, access to market data, distribution and pricing of marketing data.

About a year ago in one of the hearings we talked about it. You described it as a front burner issue. And I just want to get a sense of what you think the challenges might be to improving or leveling the playing field where market data is concerned.

I look forward to your testimony.

Thank you, Mr. Chairman.

Chairman DODD. You bet.

Senator Reed.

Senator REED. Thank you. Mr. Chairman, I would like to put my full statement in the record and just make reference.

Chairman DODD. All statements will be included.

STATEMENT OF SENATOR JACK REED

Senator REED. Thank you, Chairman Cox, for joining us today. Thank you, Mr. Chairman, for holding the hearing.

There is a growing concern that systematic risk may be creeping into our financial markets in ways that no one fully appreciates. Risk is being distributed more widely across investors, markets, and brokers, and borders.

However, as the Wall Street Journal pointed out last week, because the risk gets spread so widely regulators can do little but watch and try to reassure everybody it is all under control. A system designed to distribute risks also tends to breed it.

The proliferation of products such as CDOs that have not been tested in market downturns, the accumulation of large pools of capital in unregulated, highly leveraged hedge funds, and accounting rules that do not produce transparency in financial reporting seem to have created a potential for problems that could spill over from the financial markets to the general economy.

Bear Stearns recently announced that two of its hedge funds are now nearly worthless after some of its investments in subprime mortgages went badly. Moody's and Standard & Poor's have significantly downgraded ratings on hundreds of subprime-related bonds. The ABX index has hit new lows. Portions of this index that tracks especially risky mortgage product with junk grade ratings have been falling but now these declines are spreading to the portions of the index that tracks bonds with ratings of AAA or AA.

To quote Merrill Lynch's latest manager survey, 72 percent of managers said that credit or default risk was the biggest threat to financial market stability.

Furthermore, when we all witnessed structured mortgage products that were initially rated AAA at inception and now are trading at prices with junk bonds less than a year after issuance, there is a concern.

These events, combined with the weaknesses in the markets last week have brought many new issues to light and raised significant concerns about some of the systemic risks facing our securities markets. I would hope, Mr. Chairman, that you would address these potential risks as you present your testimony this morning and the questions.

Finally, let me comment about last week's SEC's proceedings, two distinct proposals regarding proxy access to shareholders. I am concerned about both the process associated with approving these proposals, as well as the proposals themselves.

For starters, the issuance of two diametrically opposed proposals is unprecedented by the SEC. As Commissioner Nazareth pointed out, by issuing contradictory proposals the SEC has opened the door to the possibility of cherry picking provisions from each of the proposals that may result in the worst of all worlds.

Additionally, while one of the proposals put out for comment would in theory allow shareholders access to proxies, I have serious concerns that the 5 percent threshold included in that the proposal would make any subsequent rule meaningless in its application. This threshold would limit the ability of even large long-term institutional investors such as CalPERS from having access to many shareholder proxies.

I hope the Chairman will elaborate for us on the derivation of the 5 percent threshold and direct us to the data the SEC used in setting the threshold at that level.

Clearly, there are many issues that we must address this morning. I appreciate your presence here, Mr. Chairman, and your leadership and your thoughtfulness on all of these issues. Thank you.

Chairman DODD. Thank you very much.

Senator Bennett.

STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman.

Chairman Cox, welcome. And may I thank you for your efforts to try to make Sarbanes-Oxley less burdensome. You and I have had this conversation but I hear from the venture capital community that Sarbanes-Oxley is one of the main reasons why we have had some drop-offs in IPOs. And I hear from my friends in Europe that Sarbanes-Oxley is one of the things that keeps foreign investors from coming to America to get listed on American exchanges as they previously did.

So while I think Sarbanes-Oxley has, on the whole, been good for the investing community, I congratulate you for your efforts to try to make it more sensible, particularly in terms of the smaller companies.

I will have some questions for you with respect to your recent activities on short selling, particularly the concerns about naked short selling. I appreciate the very professional way in which your staff has interacted with my staff, come to my office and spent considerable time going through these issues. I think we are moving in the right direction there.

So again, I thank you for your being here and look forward to questioning you on these particular matters.

Thank you.

Chairman DODD. Thank you. Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you. Thank you, Chairman Cox. Thank you, Chairman Dodd, for holding this hearing.

I just want to say one of my great concerns here is as the world evolves we face new challenges in financial regulation. For a long time there was sort of an exquisite balance between investor protection and entrepreneurial vigor. There is always a tension and that is part of America and that is part of the good part of our system.

The introduction of a global economy, of course, has challenged that because foreign countries can have different—will have different systems of regulation. Some have very weak systems of regulation and all too often companies go to the weakest system because it is less regulation for them. It will hurt them in the long run but in the short run it certainly hurts here.

Then there are some others, and maybe Britain is one of these, that have a better system of regulation, at least in certain aspects, not every aspect but certain. Having one regulator, having a results oriented regime may be a better way to go.

And this puts huge challenges on us. And of course, my concern is both Catholic and parochial. Catholic because I want to see the best system for everybody. It is good for investors, good for everything. But parochial, because I certainly want to see New York stay the financial center.

Now I think we can achieve that balance. I think we can adapt to the modern world and at the same time have a careful balance between entrepreneurialness and investor protection. In fact, Mayor Bloomberg and I had McKinsey do a report which had 25 recommendations how we could improve the competitiveness of America and New York and at the same time not hurt investors.

And I want to praise you because, as you know, the mayor and I have met with you on several occasions, as well as with Secretary Paulson, Chairman Bernanke, and others. We are moving in this direction and it is very helpful.

We have tried to craft most of the recommendations in the report you can do on your own that apply to the SEC, and exploring mutual recognition. That is the recognition of comparable regulatory authority by the SEC, issuing clearer guidance for the implementations of Sarbanes-Oxley, as Senator Bennett mentioned, particularly on materiality which is an issue which is important. Taking steps toward recognizing international accounting standards so foreign companies do not have to totally change their books around when they come here.

All of these are very important steps. All of these were recommended in our report. And I want to thank the SEC for moving forward in that direction.

Having said that, we have a long way to go. The increase in financial service jobs in London exceeds the increase in New York and there are other centers that are going to be nipping at our heels. So we have to continue moving in this direction, certainly continuing investor protections. Not throwing out the baby with the bathwater but updating ourselves, learning the best of other systems, and secure in the fact that we have the best talent—everyone agrees with that—here in America. And with a good system of regulation, an updated system, based basically on the basic values we have had for a long time, we can clearly stay No. 1.

So I thank you and thank you, Mr. Chairman.

Chairman DODD. Very good.

Senator Allard.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Mr. Chairman, I do not have a long statement. I would just like to thank you for holding this hearing and obviously, Senator Shelby, for working with you in setting up this hearing.

I also would like to welcome Chairman Cox. I appreciate your leadership in the SEC.

We have seen some exciting times, I think, in the SEC where around the middle of this month, July 16th to be precise, we broke the 14,000 mark. I think that creates some challenges within itself. But I think it is good news. As a result of that we have some increased volatility that has occurred.

I personally feel that it is impractical to expect our equities markets to not have to risk in it. I think risk is part of it, of the way our markets work, and I think we need to encourage an environment where people will assume some risk.

And also, I think we have to balance. I am convinced and I encourage you to continue to work for a commonsense regulatory environment, one that is not over regulatory but obviously we need some protection out there for the consumer.

I would agree with many of the comments that we got from our colleague, Senator Schumer, about how we are working with our other countries. We obviously need to work on keeping a competitive environment there. But we also have to be sensitive to the impact of Sarbanes-Oxley, the 404 provisions.

I will be interested to see how the change in the accounting rules when we went from the rule No. 2 standard to No. 5, and see over time how that is going to work out. I think it might be a step in the right direction. We have to continue to monitor that.

I think we have to continue to be very careful with the International Financial Reporting Standards. We do not want to have two separate standards, one for foreign investment and one for here. Or if we do have that, certainly our consumers need to understand the risk that is involved with that.

So I commend you. I appreciate the hard work that you have done so far, Chairman Cox. Thank you.

Chairman DODD. Thank you.

Senator Hagel.

Senator HAGEL. Mr. Chairman, thank you. I have no statement and look forward to the Chairman's comments this morning. Thank you.

Chairman DODD. Senator Bunning.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman.

Chairman Chris Cox, it is always good to see you. Thank you for being here. I look forward to hearing your update on what is going on and what we can do to make the Commission and our security markets work better.

Like many members on this Committee, I am concerned about the competitiveness of our economy at a time when jobs can easily be relocated halfway around the world. Many economies outside the United States are growing rapidly and so are foreign capital markets.

Several highly publicized reports in the last year have examined the growth and increases of competitiveness of these markets for investment dollars and jobs. The United States remains the leader of the financial world but our edge is not as great as it once was.

Several domestic factors have affected our competitiveness and need to be addressed. Trial lawyers are a big part of the problem and the fear of litigation drives businesses overseas. The same is true for our tax rates. And of course, the burdens of regulations on our businesses are a problem.

The United States is the gold standard for corporate accountability and openness and the investors around the world know that. But the burden of regulation must be reasonable to be a benefit. And this Committee and the Commission must keep a careful eye on that burden.

I am glad that the Commission finally took action to make Sarbanes-Oxley rules more workable. I am also glad that you are taking the initiative to modernize other regulations. I hope you and the rest of the Commission will continue to keep the competitiveness of our markets in mind when considering any new regulations.

In addition to our competitiveness, I am concerned about what is going on in our housing markets. The Fed bears a lot of responsibility for what is happening now. The low interest rates earlier this decade drove a credit boom and they should have been especially vigilant in monitoring the effect of those low rates. Instead they were too slow to rein in the most irresponsible practices and that made the situation worse than it could have been.

The SEC also has an important role to play in going forward. You must remain vigilant that there are no abuses in the packaging of loans into securities or in the fallout from securitized loans going bad.

As you implement last year's rating agency law, you must keep an eye on the role of the rating agencies and the mortgage mess. And you will have to decide whether any enforcement or regulatory actions are needed.

I look forward to hearing your thoughts on these issues and your ongoing work and I thank you for being here today.

Chairman DODD. Senator Enzi.

STATEMENT OF SENATOR MICHAEL B. ENZI

Senator ENZI. Mr. Chairman, I thank you and Chairman COX, thank you for being here today. We worked together on a number of issues when you were in the U.S. House of Representatives, such as collaborating on the stock option problems and working on the Export Administration Act, trying to keep the economy going while we were still able to keep national security. And of course, we were both conferees on Sarbanes-Oxley in 2002 and I appreciate your perspective on U.S. and world markets.

I appreciate the work that you and the PCAOB have been doing on Sarbanes-Oxley. I do support your final product. The key to successful implementation and financial controls testing is a risk-based top-down approach and what you have done has helped to reduce the skyrocketing costs and your management guidance and smaller company advisory panel to assist the Commission in developing tailored guidance for small public companies is a help. The scalable, as you have got it, streamlined process for making it scalable for smaller companies and I appreciate your work to continue to monitor that, as will I.

Your new accounting project, of course, the new method of accounting for U.S. issuers, we will be watching that to see how that develops and how it is accepted both here and abroad.

I appreciate the Commission's investigation of illegal backdating of stock options. The issue seems to be getting bigger as the investigations continue. I do share my support for Chairman Cox and the SEC Enforcement Division for your speed and determination with which you have been conducting these investigations. The PCAOB can also play an important role in this issue as the investigations could result in a new audit practice for firms auditing public companies.

Despite the growing amount of evidence about improper accounting and possible fraud within the suspected companies, it is important to understand that stock options remain a legitimate and useful form of compensation. Startup companies and Fortune 500 companies alike use stock options to motivate rank and file employees and attract top talent.

The Commission has set an ambitious agenda for the coming months, and I look forward to working with you and hearing your testimony today.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Let me just, before turning to you, Mr. Chairman, for your comments, we will have a markup tomorrow morning beginning at 9:30. And Senator Shelby and I are working with your respective staffs on various amendments to the bills we hope to markup.

Our hope is to be able to have an expedited markup of several pieces of legislation. I would just urge my colleagues, if they could, to come by at 9:30 so we could move rather quickly through the markup so we do not have to delay it or do it off the floor later in the morning or later in the afternoon.

Your staffs are well aware of this already and we are working very closely with them. We just wanted to mention that here this morning, if I could.

Chairman Cox, we welcome you to the Committee. Thank you for being here. It is good to have you back. We will take your opening statement.

STATEMENT OF CHRISTOPHER COX, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Chairman COX. Thank you very much, Mr. Chairman.

I am very pleased to be here today and have the opportunity to speak to you, to Ranking Member Shelby, and to the rest of the members of the Committee, about the important work that the

SEC is doing to protect investors, to promote efficient markets, and to promote capital formation.

The initiatives that we have underway at the SEC are all united by a common theme and that is the protection of individual investors, benefiting investors whose returns depend, of course, on healthy, well functioning markets. This is the SEC's traditional responsibility.

Back in the day of Joe Kennedy, our first Chairman, could marvel that one in every 10 Americans owned stocks. But today over half of all households own securities.

In fact, when one considers the staggering growth in America's individual participation in the markets, the enormity of the SEC's task becomes apparent. About 3,600 staff at the SEC are responsible for overseeing over 10,000 publicly traded companies in our markets; over 10,000 dozen advisers that manage over $37 trillion in assets. Even in Congress, that is a big number. Nearly 1,000 fund complexes, 6,000 broker-dealers with 172,000 branches, and the $44 trillion worth of trading conducted each year on America's stock and options exchanges.

Perhaps, as Senator Schumer mentioned, the most striking development in our market of late is that they are becoming increasingly interconnected globally at an increasingly accelerated rate. This is challenging the United States and securities regulators around the world to collaborate more closely than we ever have before. Investors have a lot to gain in a truly global marketplace but there are many risks and pitfalls as well. Not only issuers and providers of capital but also fraud artists have gone international.

Mr. Chairman, many of the issues that we face are sometimes trivialized as disputes between business on the one hand and investors on the other hand, as if to be pro-investor is to be anti-business, or to be pro-business is to be anti-investor.

The truth is that when people invest in a company's securities they are risking their own money on that company's success. Only if the business succeeds will their investment prosper. That is why the SEC's first chairman described the SEC's role and our relationship to business as a partnership. We take that to mean today, just as when Joe Kennedy was chairman, that if a business is investor friendly the SEC will be friendly to it. But anyone who seeks to drive a wedge between the interest of the business and the interest of investors in that business will face a relentless and powerful adversary in the Securities and Exchange Commission.

Today the SEC's Enforcement Division is significantly larger than it was 5 years ago. Our staff is engaged in combating abuses that range from boiler rooms and Ponzi schemes to stock option grants made to fictitious employees. We are pursuing individuals and firms who have falsified corporate documents, engaged in self-enrichment to the detriment of their investors, and attempted cover ups of this sort of conduct. We are investigating and filing actions against perpetrators of Internet scams, pump and dump schemes, and prime bank frauds, and executives who have lied to their auditors. We are going after accountants, lawyers and other gatekeepers who have joined in those frauds themselves.

The Commission is also making increasing use of the new authority that you gave us in the Sarbanes-Oxley Act to use Fair

Funds to ensure that the monies that we recover through our enforcement efforts go straight back to the injured investors without deduction for lawyer's fees as quickly as possible. Through this program we have already returned over $2 billion to investors. We are rapidly developing a considerable expertise in the distribution of these billions in Fair Funds, which I intend to accelerate through the creation of a dedicated office that will specialize in this area. That new office will be up and running by October.

Of course, enforcement almost always comes after the fact, when investors have already been injured. But investors are best protected when securities firms have robust compliance programs to prevent violations. That is why the Commission has taken new steps to help securities firms meet their compliance obligations, including our CCOutreach program which helps chief compliance officers and mutual funds and investment advisers to implement strong compliance programs for the protection of investors.

Beyond CCOutreach, we are publishing information about the common deficiencies we find in examinations to help securities firms improve their own compliance programs.

Beyond the SEC's enforcement and compliance efforts, we have undertaken a variety of initiatives and rulemakings to protect investors and increase the efficiency and competitiveness of our markets. Perhaps the most important step we have taken this year is to rationalize the implementation of Sarbanes-Oxley. We have just approved new guidance for management in implementing Section 404 of the Act. Just last week the Commission voted to repeal the auditing standard that had made Sarbanes-Oxley Section 404 so expensive and replace it with a new standard that is half as long, written in plain English, and that is principles based, top-down, scalable for companies of all sizes and focused on what is truly material to the quality of the financial statements.

These actions represent over 2 years of hard work aimed at addressing the problems with 404 implementation that this Committee has very properly focused on.

With these improvements to 404, no longer will the auditing standard be the de facto rule book for management's compliance with our rules. For those smaller companies that have not yet come into compliance with Section 404, the guides will permit them to avoid the wasteful and unnecessary compliance efforts that others have had to endure. For these smaller companies we have once again deferred, for the fourth time, the external audit requirement under Section 404. So management will have another full extra year, until 2009, to develop its own cost-effective compliance approach.

When eventually these smaller companies do come into compliance, they will find that the new standard encourages the scaling of all audits. Small companies will be able to apply the guidance to their unique control systems rather than create costly and complex control systems that follow the one size all checklist approach that many larger companies have had to endure is they have struggled to comply with Section 404.

As a result of these sweeping changes, the SEC and the PCAOB expect a change in the behavior of the individuals who are responsible for following these new procedures. To that end, the PCAOB's inspection program will monitor whether audit firms are implementing the new auditing standard in a cost-effective way and the SEC, in our oversight capacity, will monitor the effectiveness of those inspections.

The Congress has charged the SEC with making Section 404 work both effectively and efficiently. We recognize that doing so will greatly benefit U.S. investors as well as the competitiveness of U.S. companies and financial services providers throughout our global capital markets.

Another significant effort the SEC has undertaken is our focus on helping seniors. Last year we organized the first ever Seniors Summit with our fellow regulators and law enforcement officials from across the Nation. This September we will host the second annual Senior Summit which will integrate even more of our national resources.

We are attacking the problem of fraud against seniors from all angles, from aggressive enforcement efforts to target examinations, and investor education. We have brought 26 enforcement actions during the past year aimed specifically at protecting elderly investors. Many of them coordinated with State authorities.

Beyond enforcement, education is a vitally important tool in fighting securities fraud against seniors. The SEC's education efforts are aimed not only at seniors but also their caregivers and the over 100 million pre-retirement workers who are in need of planning now for contingencies in later life.

We are reaching out to community organizations and enlisting their help in educating Americans about investment fraud and abuse directed at seniors. We have also devoted a portion of the SEC website specifically to senior citizens.

The SEC has also identified another at-risk group that is vulnerable to unscrupulous sales practices for financial and investment products, and that is the men and women of our military. We worked with you and the Congress to enact the Military Personnel Financial Services Protection Act just last year to prevent the sale of potentially abusive insurance and investment products to military personnel and we back that up with enforcement, examinations, and investor education to protect against these abuses.

We have also initiated a coordinated approach with other regulators to protect America's servicemen and women.

Today, I would like to announce another important initiative in the SEC's investor education and investor advocacy missions. We will be expanding the role of investor education and our focus on the needs of retail investors through our new Office of Investor Education and Advocacy.

The new name connotes expanded responsibilities, including the appointment of a new director who will focus on the specific needs of individual investors such as whether the disclosure they receive is understandable and how they can get redress for problems with their retail brokerage in their individual investments.

Kristin Kaepplein, who until recently was the Vice President for Global Compliance at Goldman Sachs, will lead this expanded office and two new units within it, the Office of Policy Investor and Outreach and the Office of Investor Education. The existing Office of Investor Assistance, which hear year has contact with tens of thousands of individual investors, will also come under the new Director's responsibilities.

Tapping the power of new technology is key to the Commission's efforts to put individual investors first. Our recently adopted electronic proxy rules will allow individual investors the choice of getting their proxy materials online where they can search the information and also link to other explanatory materials as well as, in the future, gaining access to interactive data that will let ordinary investors sort through mountains of SEC mandated disclosure and turn it into something meaningful.

What we are calling interactive data will provide owners of stocks, mutual funds, 401(k)s, far more useful information than anything that they have ever gotten from the SEC before.

The SEC's current online system, known as EDGAR, is really just a vast electronic filing cabinet that does little to exploit the power of today's computers. It can bring up electronic pieces of paper on your computer screen but it does not let you do much with it. Interactive data will change that by allowing investors to quickly find, for example, a mutual fund's expense ratios or the mutual fund with the lowest expense ratio, the company within an industry that has the highest net income, or the overall trend in their favorite company's earnings.

The Commission is investing over $54 million over 7 years to build the infrastructure to support widespread adoption of interactive data. Companies that are pioneering this new technology have told us that there are substantial benefits that will exceed the minimal costs. Interactive data can make company's internal processes more efficient and cut the costs of registration and compliance reporting to the SEC.

Yet another initiative the Commission is pursuing is improving the way shareholders can interact with each other and with their companies using the Internet. In the course of addressing the question of shareholder access to the company's proxy materials, the Commission has also proposed changes to the proxy rules designed to remove obstacles to electronic shareholder communications.

The proposal would clarify that a company or a shareholder who maintains an electronic shareholder forum is not liable for statements by any other participant in the forum and it would clarify that participants in electronic shareholders forum would not themselves be engaged in a proxy solicitation.

Ultimately, empowering shareholders and issuers is the key to keeping U.S. markets competitive because capital will flow to where it is treated well. We are confronting the challenges and opportunities of more foreign listings here in the United States in a number of ways, not least of which is our consideration of International Financial Reporting Standards. Last week the Commission voted unanimously to publish a concept release for public comment on allowing U.S. issuers, including investment companies, to prepare their financial statements using International Financial Reporting Standards as published by the International Accounting Standards Board.

A truly global set of standards, which is what we are investigating, would allow investors to draw better comparisons among investment options around the world. It would also potentially lower costs for investors and issuers who would no longer have to incur the cost of maintaining and interpreting financial statements using different sets of accounting principles.

Yet another way that we are addressing the international character of our securities markets is exploring the merits of a mutual recognition approach to facilitate global market access. Just last month the Commission hosted a roundtable on mutual recognition where distinguished representatives of United States and foreign exchanges, global and regional broker-dealers, retail and institutional investors and others shared their views on the possibility of mutual recognition.

Although the details of a viable mutual recognition approach are still in the works, any such approach would depend on these entities being robustly supervised and regulated in their home jurisdictions. And that home decision would have to provide substantially comparable oversight to that here in the United States.

A mutual recognition regime would consider, for example, under what circumstances foreign exchanges could be permitted to place trading screens with U.S. brokers in the United States without full registration.

Mr. Chairman, the final area that I would like to address is the way the SEC is confronting emerging risks in our global markets. As elsewhere, our strategy begins with enforcement where we have created special working groups within the Enforcement Division to deal with emerging risks including stock options backdating, microcap fraud, and hedge fund insider trading.

In the past few years, the Commission has brought numerous enforcement actions alleging that hedge fund portfolio managers engaged in insider trading. The Hedge Fund Working Group within the Enforcement Division is coordinating with other Federal law-enforcement agents and self-regulatory organizations.

In March of this year, the Commission filed cases against 14 defendants alleging one of the most pervasive Wall Street insider trading rings since the days of Ivan Boesky and Dennis Levine. We alleged that participants in the scheme included several hedge funds and their portfolio managers.

In another recent case, we charged a family insider trading ring with a multimillion dollar scam that they carried out by creating a hedge fund to conduct the insider trading and to disguise their identities.

We have also brought a number of enforcement actions against hedge funds and their portfolio managers who, we alleged, made millions of dollars by trading illegally on inside information regarding so-called PIPE stock offerings.

In addition, the Commission has brought cases against hedge fund managers that we charged with trading on the basis of inside information ahead of mergers and acquisitions.

Earlier this month, the Commission voted to adopt a new hedge fund anti-fraud rule permitting investment advisers from defrauding investors and prospective investors in the funds. This rule will help the Commission police the hedge fund market. It will help us to deter misconduct and to call to task those who engage in such misconduct.

Another area that we have identified as an emerging risk is the municipal securities market, which is now $2.4 trillion in size and over $6 trillion in annual trading volume. Last year $430 billion of new municipal bonds and notes were issued, many not by governments but by essentially commercial enterprises that structured their finances to gain the advantage of the tax-free borrowing rate.

When the Federal securities laws were originally enacted 70 years ago this was a small quiet market dominated by institutional investors. But today the majority of the investors are individuals, either directly in the form of households or indirectly through mutual funds, money market funds, and closed end funds. Despite its reputation as a buy and hold market, municipal trading volume, at over $16 trillion last year, is similar to what we see in the corporate bond market.

While the SEC has anti-fraud authority, which means that we can come in and clean up the mess after it has happened, we do not have the authority in the municipal securities market that we have in the corporate securities market to insist on the disclosure of material information to investors at the time that the securities are being sold.

I hope that, working with this Committee, we can consider ways to make disclosure information available on a more timely basis before the sale of municipal securities and to consider other ways of protecting investors, including the use of generally accepted governmental accounting standards, SEC oversight of the Governmental Accounting Standards Board, and clarifying the legal responsibilities of issuer officials, underwriters, bond counsel, and other participants in the offerings.

Mr. Chairman, this is a necessarily summary description of just some of the most important work underway at the SEC. But it is a fair survey of the regulatory and enforcement landscape and the domestic and international challenges that we face in the days ahead.

I want to thank you for the opportunity to appear before the Committee. I look forward to working with you and to meeting the needs of our Nation's investors, issuers, and markets.

I would be happy to take your questions.

Chairman DODD. Thank you very much, Mr. Chairman.

What I want to do, since we have a pretty good turn out here, Senator Menendez and Senator Reed will be back, is I will make it 6 minutes a round. That way we can get through a lot of people here quickly, maybe get one or two questions in, and we will try and move along so we cover as much ground as possible.

Let me pick up, if I can, in my first question to you, a matter that Senator Reed raised earlier with you in his opening comments. And that is regarding the Commission's votes, I will use the word plural here, to issue for public comment on the two proposals that were almost the opposite of each other.

One would have allowed shareholders who own 5 percent of a company for 1 year to propose changing bylaws governing how directors are elected. The other would prohibit all shareholders from putting forward the same type of election-related proposals.

I have been on the Committee for 26 years, Mr. Chairman. Correct me if I am wrong, and I am sure you have had your historians at the SEC go back and look at this, if there has ever been an example where a Chairman has voted yes on two absolutely contradictory proposals, carrying both of them by three to two margins here.

The issues that have been raised by Senator Reed are very important to me, and I assumed to other members as well. One, explain how the reason the Commission would issue two similarly contradictory rules for your votes? I understand you want to get opinions on these matters. I understand that. But I do not understand why you would have two contradictory rules to get the opinions.

What actions will the Commission take or not take on shareholder proposals on the subject prior to the Commission's adoption of a final rule?

Again, the point of 5 percent ownership here, again it raises some questions regarding some rather large investors in terms of their ability to have some say. What types of investors would be included if the 5 percent threshold would be maintained?

So I think some explanation is needed here, Mr. Chairman.

Chairman COX. Thank you, Mr. Chairman. You put three questions to me: why two proposals? What actions might we take prior to their implementation? And why 5 percent?

First, with respect to why two proposals? The proposals are very different but they do have one essential element that is in common. They have the same foundation. And that is the long-standing interpretation of the Commission's existing rule, under which a proposal by a shareholder to amend the company's bylaws concerning the procedures for election of directors could be excluded by a company from its proxy materials.

Chairman DODD. That went back to 1990.

Chairman COX. That goes back to 1990.

Chairman DODD. Prior to 1990 it was a different rule.

Chairman COX. From 1976 to 1990, the Commission staff interpreted the provision differently, although quite frankly we did not have much incidence of that kind of proposal at the time.

But the proposal, which I will refer to for ease of distinction here as the longer proposal, that would permit such bylaw amendments to have access to the company's proxy materials, is based on that operating presumption of how if a company did not make such an election the world would work. So that proposal, that essential proposal, is the same in both.

What is different, of course, is whether or not a company and its shareholders would have the opportunity to design a system that they think is right for them, whether shareholders would be able to propose it, whether the company would be able to propose it and the shareholders approve it.

My personal view is that there is much merit in that kind of an approach. We do not have, among all five commissioners, a clear agreement on all of these issues. But we are under a very significant constraint, a time deadline that is imposed by the combination of a court decision and the upcoming proxy season.

What I have publicly stated it, and I am happy to repeat here, several times is that there will be a rule in place this fall, this coming proxy season, so that people will know how to conform their conduct to the law and to the rules of the SEC.

In order to put a rule in place, I have got to have a clear idea of what the commissioners want to do and which commissioners I am voting with, and which commissioners, by the way, are members of the SEC. All of these things somewhat up in the air right now.

And so we will have elaborate opportunity for comment on these two proposals. They do have some things in common. And with the benefit of that I think we will be able to continue our discussions.

If we were not operating under the constraint of a court decision and this fall deadline I think, rather than put the two proposals out there and let everybody see our work in progress, we would have just continued to consult with each other a little bit longer. With respect to——

Chairman DODD. The 5 percent.

Chairman COX. The 5 percent, what the SEC's existing role and existing interpretation are premised upon is that investors need disclosure if there is going to be a proxy contest about who they are dealing with and what is going on around the contest. I think all of the commissioners are agreed that that is important.

And so in both proposals there is a sturdy mechanism to make sure that that disclosure is provided, that the proxy contest rules, for example, would apply even if a company adopts its own bylaw with its own procedure that might be different from our current rule.

The 5 percent disclosure threshold in our existing 13(d)/13(g) regime is what we adopted so that there is something that has legal precedents, that people know how to use it. Were we not to have done that, then the disclosure regime would have to have been invented from whole cloth. It would have been a much more significant if not daring undertaking.

There are certainly other ways to do this. It is not anything in nature that requires the 13(d)/13(g) regime to be built upon 5 percent.

But I will say this also, that in the aborted 14a-11 proposal that was advanced by the Commission a few years ago and never finally acted upon, there was a 5 percent threshold. We have consulted with a number of investors and investor groups and there is significant support, as well as significant opposition, to the 5 percent threshold.

But there is one piece of this proposal that might be being overlooked that I hope the comment period will help to flesh out. And that is electronic shareholder form that I described in my opening statement. The 5 percent does not need to be a 5 percent investor. It can be a group. And one might credibly inquire whether if you cannot put together a group of 5 percent to propose a bylaw, whether you could ever get 50 percent to pass it. There is not any empirical evidence on this, of course, because this has not been attempted before.

So we will see what the comment provides. But the opportunity that investors will have to speak with each other very freely and very inexpensively on the Internet without concern about the proxy rules, were this proposal to be adopted, would be a way to put together a 5 percent group that does not exist today.

Chairman DODD. I thank you for your answer here and I appreciate the time constraints you are operating under. Let me just say here again, speaking as Chairman but obviously as one member here as well, that my hope is that the Commission would be able to resolve this, keeping in mind the importance of investor rights in all of this.

But also to say to you, Mr. Chairman, that it is something that the Committee might consider legislatively in dealing with it. I do not jump to that. As you know, I am reluctant over the years to have the Committee jump into matters that more properly belong in the regulatory framework rather than the legislative framework. But this is one area where I might express some interest legislatively if the Commission is unable to come to a conclusion promptly on this. So I raise that for you for your consideration.

Chairman COX. I appreciate, Mr. Chairman, the extra encouragement. But as I stated, we will do a rule and we will have it in place this fall.

Chairman DODD. I am glad about that.

I have some questions about hedge funds and so forth, but my time has expired. Let me turn to Senator Shelby and I—if I can come back later on.

Senator SHELBY. Thank you, Mr. Chairman.

Credit rating agencies. President Bush signed the Credit Rating Agency Reform Act into law last September, as you know, Mr. Chairman. My goals in drafting that legislation were to replace an opaque SEC staff designation process with a transparent registration system, promote competition in a highly concentrated industry, and establish a regulatory framework giving the SEC statutory authority to supervise rating agencies.

Since the legislation was enacted, Mr. Chairman, much attention has focused on the role of the credit rating agencies and structuring subprime loans into securities, as well as the accuracy and quality of the ratings issued on these securities.

In light of all the serious concerns that have been raised, what is the Commission currently doing to supervise the rating agencies? Chairman Cox, have the rating agencies followed all of their publicly disclosed procedures and methodologies? And how would you make that determination, if you can?

It is a big concern to us when you are rating subprime securities or loans constituting subprime loans, securities constituting highly rated, and then we know they are junk. Now they are downgrading them. And you know what is going on in the subprime market. It is a concern to us.

Chairman COX. These are two big issues for the SEC colliding and mutually reinforcing one another. Congress has given us significant new responsibility over NRSROs which we are now executing upon. We have adopted rules, as you know, and we are devoting new resources to our responsibility to oversee registered ratings agencies.

Any examinations that we conduct, I should add to clarify at the outset, would not in any circumstance evaluate the opinion that was expressed in a particular credit rating. But rather we would be focused upon the existence and the effectiveness of a rating agency's policies and practices regarding matters such as conflicts of interest and their handling of material nonpublic information.

On the other hand, our ability to examine the NRSROs will, if such a thing were ever to occur, give us the opportunity to use the enforcement powers that we have always possessed in this area more effectively.

Senator SHELBY. We have given you a little more tools than you had, absolutely, have we not?

Chairman COX. Indeed.

Senator SHELBY. I hope you will use them for the benefit of the public.

Chairman COX. We are definitely using them.

Senator SHELBY. Competitiveness. We have been talking about this here, and you do, too. Since your last appearance before the Committee, a number of reports have been issued suggesting that excessive regulation and litigation is harming the competitiveness of U.S. capital markets. These are factors unlike globalization and technology that we have some control over in this country.

I believe the next few years are a critical period, making it imperative for us to create a regulatory structure that can adapt to the rapidly changing global environment that you are confronted with every day.

The SEC, I understand, has embarked on a number of initiatives to address some of the problems identified in these reports. In your estimation, Chairman Cox, what is the single most important action the Commission has taken or is likely to take that will strengthen U.S. markets as far as competitiveness is concerned? And what is the most important thing that Congress, that we could do in this regard to help, in your judgment?

Chairman COX. As you indicate, Senator, we are taking a number of actions. And I do not want to, by answering your question directly, suggest that these others are not nearly as important. But I do not think there is much question, addressing the challenge of Sarbanes-Oxley and, in specific Section 404, is of vital importance to the competitive position of U.S. markets in the world.

I say that because even though we are all very, very familiar here, certainly on this Committee but also in our markets and across the country with the problems for example of Section 404, in Europe and in Asia and the rest of the world it starts to get a little fuzzy. People are not so focused on the detail as on the brand name of Sarbanes-Oxley and the pathologies that it is supposed to connote.

So by directly addressing this problem and by discussing it in real time with our counterpart regulators overseas and with other market participants, I think we are going to make a big and a clear impression that this change, that it is going to be fixed, it is going to be addressed. And not only that, but it is going to be made to work. So we are not making it go away, we are making it efficient, cost effective, and getting all the protections for investors that Congress wanted that I believe and I think most of you believe undergird our markets and make them more competitive.

Senator SHELBY. Last week the Commission issued a concept release on the future role of International Financial Reporting Standards in U.S. markets that raises a number of questions including whether U.S. issuers should be permitted to prepare financial statements in accordance with International Financial Reporting Standards for purposes of complying with the Commission's rules and regulations and without reconciliation with the U.S. GAAP.

In addition, it is my understanding that the Commission proposed to eliminate the requirement that foreign private issuers who file financial statements using International Financial Reporting Standards also submit a reconciliation of those financial statements to U.S. GAAP. This is a big departure but it might be where you are going.

This transition to global accounting standards has profound implications for the capital markets. What is the most significant challenges here in the next few years? We have worked on this with you before but this is changing. Is it for the better? And will it help us compete?

Chairman COX. These are exactly the right questions and we do not have the answers right now. For that reason we have just voted to publish a concept release which is itself a long list of questions. We expect to have a good deal of public input from around the world and certainly from this country about what IFRS means for the future of U.S. markets.

But I think we need to take a step back and recognize that the United States has been consistently supportive of the development of IFRS.

Senator SHELBY. Absolutely.

Chairman COX. We know that Paul Volcker was the Chairman of the IASB. The U.S. has been the largest financial supporter of the development of these standards. Europe has now mandated this for all of its member states starting in 2005.

Senator SHELBY. There has got to be a convergence somewhere, has it not, between our standards and their standards?

Chairman COX. Yes. And the U.S. participation has been focused on a very sturdy effort between the FASB here in the United States and the IASB to converge the two systems so that in the future this question of IFRS versus U.S. GAAP will not be such a consequential one. It will be much more a question of how we accommodate and facilitate comparisons around the world.

I do not think there is much question in the abstract that if there could be such a thing that we would all agree is a global set of high standards that are consistently and fairly enforced everywhere in the world that we would all be better off. That is what we are trying to build toward. I do not know if we are there yet. And whether or not this is ripe for the United States in the near term is the question we are asking.

Senator SHELBY. That is equivalence. The term we are working at is equivalents, in a sense; right?

Chairman COX. At least that, yes. And I do not think there is much question that we are nearly there with equivalence. Foreign private issuers are filing their financial statements in the United States with IFRS already. The SEC now has a few years of experience in analyzing those. We have trained up all of our people and we are certainly capable in that respect.

The rest of the United States, the accounting firms, schools of accounting, and so on, have quite a ways to go in this respect. So we are very much on the leading edge of these questions.

Senator SHELBY. Thank you. Thank you, Mr. Chairman.

Chairman DODD. Senator Sununu.

Senator SUNUNU. Thank you, Mr. Chairman.

Chairman Cox, I would like to begin with the issue of market data. Some time ago, in a presentation before the Committee, you talked about the efforts of the Commission or at least the relative importance of the Commission dealing with market data revenue, access to data, and distribution of the revenue.

Has the Commission come to any conclusions? And what do you think the issues are that stand in the way of taking action in this area?

Chairman COX. We are very intently focused on this. Since the last time that we discussed it in this Committee, the Commission has granted a petition by the Net Coalition which, as you know, is a trade organization of Internet companies, to review the staff's approval by delegated authority by NYSE Arca proposal to begin charging a fee for its depth of book data.

The staff is currently preparing a new order for the Commission that would approve the fee primarily because NYSE Arca was subject to significant competitive forces in setting the fee.

In addition, since the NYSE and NASDAQ have filed proposals for innovative reference data products that make economic sense for advertiser supported Internet companies like Google, Yahoo, and CNBC, those would be encompassed by this as well.

Senator SUNUNU. You also talked about XBRL. I guess you did not use that language. You simplified it for us a little bit. But the importance of having systems in place that make it easier for investors and businesses to make use of the store of information collected by the SEC.

In my notes, I am shown that about 40 companies right now are voluntarily providing data to the SEC that is tagged with this data format that makes the information more accessible.

In your written testimony you spoke of $54 million that was going toward the implementation of this kind of data formatting. Have you set out any timing or milestones for getting more companies to use this format in order to make the data more accessible? You have 40 companies filing with coded filings to the Commission now. Out of how many total firms is that, that are filing? It is obviously a small percent but when do you expect to see more progress?

Chairman COX. First, let me tip my hat to the participants in our pilot program because what they are doing is they are doing it the old way and the new way. There is really not a whole lot of purpose, other than being early adopters and getting ready and helping the SEC to beta test the system in their doing this. You would imagine that they would stop if it were harmful or painful or expensive.

But what we are finding from our test filers is that the amounts of money that they are spending to do this are trivial. And they are already seeing internal benefits to themselves in having this sort of automation of the preparation of financial information. It is more accurate. It is easier to keep track of. It can speed up their internal processes as well as make the output better.

But it will remain for volunteers to do this in relatively small numbers unless and until two things happen. First, there is a completed cookbook or rulebook—I hate to use the word taxonomy, which is the favorite term of XBRL mavens—for all of U.S. GAAP. We are very, very close to achieving that. It should be completed in the third quarter of this year. That means that there will be about 15,000 little labels or recipes that people can put on their data. They will all be standardized and they will not have to be customized, as they are now.

Microsoft, just as one example of a company that is a volunteer filer in our test program, has approximately 600 customized extensions that it is using. Customization is sort of at odds with what we are trying to accomplish here because we want comparability and we want everybody to be able to find what they are looking for without a lot of prior knowledge. And so using the completed taxonomy for all of U.S. GAAP will permit them to take the next step forward.

Assuming that this all works, I would say by the end of the first quarter of next year or at least by the time people file their 10–Qs using the new completed taxonomy, we will have a good idea from the test filers whether they like it and whether it works. They are then in a position to be evangelists to others and say take it on, try it, and do it.

The second thing that will have to happen is that we will have to make it possible for people to stop doing it the old way so that there is some real benefit in people signing up for this, rather than filing all of your interactive data XBRL stuff as an exhibit to the current disclosure that is already required. I think when we do that, even if we were not to mandate it, we would get a lot of take up.

Senator SUNUNU. To the second point, is there any information or transparency that is lost if someone were to convert over——

Chairman COX. To the contrary, there is much more information provided because now you have got all of the stuff you used. You have all of the financial statements, which now are susceptible to being represented on a piece of paper, and you have made it all interactive.

Senator SUNUNU. So if we add, just hypothetically, if you add a system where you could file either way there would still be full disclosure or disclosure at least to current standards?

Chairman COX. Yes. And one of the things that the SEC has done with our modest investment is that we have built a software tool that will permit rendering on our own website all of the XBRL gibberish, the computer language that people are really filing in, rendering that in a way that people are used to so it looks like a piece of paper.

Senator SUNUNU. Excellent.

Back to the issue of timing, you think that the standard lexicon for tagging this data should be completed by the first quarter of 2008. Do you expect to have more than a handful of companies filing voluntarily in this format by the end of 2009? Or do you think that it will be about the same that we have now?

Chairman COX. By the end of 2009?

Senator SUNUNU. I am sorry, 2008. But the end of 2008.

Chairman COX. That is a great question. I think this is going to be the real test of this whole opportunity. 2008 will be the no go or go year.

Senator SUNUNU. Thank you. Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator.

Senator Reed.

Senator REED. Thank you very much, Mr. Chairman.

Again, thank you, Chairman Cox.

Over the last several months we have been looking in the Subcommittee about the mortgage securities market, CDOs, and have discovered that these are extremely complex instruments that are virtually illiquid. And rather than mark to market, they mark to a model or they mark to a rating by the rating agencies.

How comfortable are you with this approach that these instruments really do not get tested by the market? In fact, there is a strong suggestion as when funds were given the choice between disposing of their assets in the marketplace or a parent's firm, providing resources, the parent's firm sort of paid up rather than trying to mark them to market.

How comfortable are you with this situation?

Chairman COX. Senator, as you know, we are very much focused on issues such as valuation and, in particular, the impact of subprime lending on the CSC firms that we regulate. On the other hand, we are not a front-line regulator for the subprime lending industry. Our Division Enforcement, in particular, is constantly on the lookout for possible securities fraud involving subprime mortgage lenders.

As I mentioned in my prepared remarks, they have formed a working group specifically focused on nationwide efforts in this area.

The risk that you have identified, I will say, is a real one. And it is one about which the SEC is concerned. And so we will use the tools that we have and the piece of this that we are responsible for to go after it.

Senator REED. Is there an effort to coordinate your activities with other regulators, the Federal Reserve?

Chairman COX. Very much so. As you might imagine, given the broad market impact of this entire area, this is a subject of special concern to the President's Working Group on Financial Markets. As a participant in that group, I am sharing the SEC's expertise and resources with the other members, including the Treasury, the Fed, CFTC, as well as with other banking agencies that are not directly participants in the PWG.

Senator REED. A related question that goes to the issue of systemic risk which concerns all of us and it is probably the bottom line of what we have to worry about at the end of the day.

With a tightening liquidity which is becoming more apparent, with higher interest rates and potentially going higher, and with hedge funds who are very difficult to understand the types of transactions and portfolios they have, with access to huge amounts of money, where in a day there could be a wrong bet that they would have significant repercussions in the market.

Do you think the regulatory structure is adequate at this moment? Are there authorities that you lack? Is there a gap between what you are doing and the Federal Reserve is doing that has to be addressed?

Chairman COX. Are you asking with respect to hedge funds, private capital, or——

Senator REED. I am asking with respect to the issue—hedge funds being one actor or the significant actor in the marketplace. But looking at your course of situation of tighter liquidity, rising interest rates, hedge funds, private equity funds, some of them regulated, some not regulated. Do you feel you have the authority to deal with the potential systemic threat?

Chairman COX. The first way to deal with potential systemic threat is to be inductive and to learn what is happening. And in that respect, we are doing a good bit of sharing and a lot more than we ever used to with our international regulatory counterparts.

We are also doing a much better job, I am sure, than ever was needed before, at sharing inside the U.S. Government. So I think we are increasingly getting a clearer picture of what is going on in terms of liquidity and the global financial system.

The second thing that we have to do to deal with the potential risk in this area is to have rules and authority over the marketplace actors that might be violating our precepts or our laws. And in that respect, we do need to do more. I have been busy executing memoranda of understanding with our counterpart regulators around the world. Those MOUs typically begin with the enforcement piece and sharing information for that purpose. They then extend to, when they become more mature as they have with several European countries, they then extend to reinforcing mutually our respective regulatory regimes.

The last thing I would point out is that if one is looking at the global financial system, it is impossible to do so—and if you are attentive to the risks posed by hedge funds, which tend to be black boxes, without being attentive also to the rise in significance of sovereign wealth funds. As you know, they are projected to grow over the next 8 years to potential $12 trillion in size. They are less transparent, significantly so than hedge funds.

They also differ from hedge funds in the sense that they may have motives for their investment decisions that go beyond mere profit and loss.

And so understanding the impact on liquidity and on the safety, security and soundness of markets, the efficiency of markets, and setting prices and allocating resources is going to become very, very much more difficult if the next 8 years really looks as has been projected.

Senator REED. Thank you very much, Mr. Chairman.

Thank you, Chairman Cox. Thank you.

Chairman DODD. Thank you. Senator Bennett.

Senator BENNETT. Chairman Cox, you and I have had this conversation but now let us have it in public.

I understand that this is a relatively small issue when you take the trillions of dollars that trade every day, but I am talking about primarily in the pink sheets naked short selling.

As I have spent time with this issue, I think I have put my finger or tried to put my finger on what the basic problem is. When we talk about banks, a bank takes deposits and then a bank makes loans. And in the process the bank loans more money than it has on deposit and thus creates money.

We have the DTCC that takes deposits. In this case, it is not money, it is shares of stocks. And then the DTCC makes loans, shares of stock to be available as borrowed shares for those that are selling short. My concern is that the DTCC is beginning to act like a bank. That is, just as a bank loans more money that it has on deposit and creates money, the DTCC is loaning more shares than it has on deposit and is creating shares, creating phantom shares.

Now I do not think they are doing it deliberately. I want to make it very clear. I think the DTCC is an essential entity without which the markets could not function. I do not mean to be listed as one who is critical of them. But I think inadvertently we have gotten into a position where phantom shares are being created.

I salute the Commission on your June 13 statement that you will be eliminating the grandfather provisions of Regulation SHO. But I would like to know exactly when that whole situation will be finalized, and then get into some suggestions as to how we might deal with this problem.

When does the Commission intend to publish the grandfather exception amendment? With what effective date?

Chairman COX. Senator, as you know, we have actually voted to repeal the grandfather. Let me inquire about the date of publication.

It will be effective in October, we believe.

Senator BENNETT. I see. OK, that is helpful.

I have three ideas that I will share with you here to deal with the question of phantom shares.

No. 1, when a broker wants to make a short sale he will call another broker and say do you have 1,000 shares of XYZ stock that I might borrow to cover a short sale? And the second broker says yes. The first broker says well then, I will get back to you.

A third broker calls and says do you have 1,000 shares of XYZ stock that I might borrow? Yes. OK, I will get back to you.

Both broker one and broker three then make the short sale and come back to broker two and say OK, I want the shares. And broker two says I only had 1,000.

Is there any way the SEC could take action to say that there must be an exclusive commitment on shares that would be loaned to cover so that you could not inadvertently create phantom shares in the situation I have described?

No. 2, is there any way the SEC can say to the DTCC you cannot loan out any more shares than you have on deposit? If you have on deposit 3 million shares, you cannot loan out 3.5 million or you cannot allow anybody to put claim on 3.5 million. That when the total number of shares that they have on deposit has been loaned out to cover short sales, that is it. It seems to me that would be very helpful.

No. 3, do you have the authority to say that no broker will receive any compensation, either in the form of cash or credits of any kind, until the shares have in fact been delivered? I do not mean delivered to cover the short. I mean delivered in the borrowed sense, that we really have identified the shares that we have sold short against. We have identified their source and nailed it down. And then, once that has been done, the broker can receive compensation.

These are the three things that seem to me to be commonsense ways to prevent the creation of phantom shares. I am wondering if you have the authority to implement any or all of them?

Chairman COX. Thank you, Senator. In preparation for this hearing I inquired specifically about the proposals that you just described because you have described them previously and asked us to see what we can do in this area.

And so at the time of our vote in the Commission on repealing the grandfather clause under Reg SHO, I simultaneously instructed the staff of the Division of Market Regulation to study anything and everything else that we might do in this area to put a halt to the maximum extent that it is humanly possible without disrupting the whole clearance and settlement system to illegal naked short selling.

As you know, in addition to what we might do in a regulatory way through the Division of Market Regulation, we have also been bringing and will increasingly bring enforcement actions in this area because when it is intentional it is illegal.

You have asked us also about inadvertent phantom shares creation and whether or not there is a way to stop the clearing agencies from dealing in shares that they do not have. When securities at DTCC are loaned from one participant to another, the shares have to actually be on deposit in the leading participant's account, even as it stands right now. They are moved from the lending participant's account to the borrowing participant's account. The lending participant at that point cannot relend them or cannot sell them or alienate them or otherwise do anything with respect to them unless and until they are returned by the borrowing participant.

And of course, neither DTC or NSCC, the National Securities Clearing Corporation, knows or has any way of knowing whether or not the securities transactions that are submitted for clearance and settlement are related to short sales.

Senator BENNETT. The only concern I have, I have been brought along with an understanding of this. But I have had shown to me companies that have gone out of existence whose shares are still trading. The reason they are still trading is that every 13 days broker A rolls them over to broker B and says well see, I have covered or I have borrowed the shares. Then broker B, 13 days later, rolls them back and says well, I have borrowed the shares. And it goes back and forth.

And there are companies, 2 years after the company ceases to exist, their shares are still trading.

Chairman COX. Those are cases where we are able to target our enforcement resources. Obviously, the leverage that one gets from illegal naked short selling is greatest in these thinly traded issues.

Senator BENNETT. Yes. It is a very small, small area of the vast amount you have to oversee. And I keep focusing on it. But for the people who are in it, it is very important.

Chairman COX. This is one of the reasons that we created a special task force in the Division of Enforcement focused on microcap fraud.

Senator BENNETT. Thank you very much.

Chairman DODD. Thank you very much, Senator.

Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

You had mentioned in your comments about looking at further rules and regulations as far as municipal bonds are concerned. Right now municipal bonds are rated as to risk. Why isn't that adequate for serving the current market?

Chairman COX. Corporate debt is also rated. That is one piece of a whole system that is supposed to give the market the kind of information and transparency it needs to price assets.

The truth is that the standards for municipal securities are nowhere near what they are in the corporate market. And what has happened over a period of many decades is that the municipal market has matured to a point where it is every bit as significant and, in terms of its involvement with a variety of financial instruments, every bit as sophisticated as the corporate market.

But there is no way for investors to require or demand the kind of disclosure that they would routinely get for the same kind of debt instrument were it a corporate issue.

Senator ALLARD. What types of regulation? Are you looking at the same type that you apply to the corporate market? Is that applicable to the municipal market?

Chairman COX. No, is the short answer. But certainly what we are looking for are things that we have become accustomed to in the capital markets more generally. But the model of regulation should not, and I do not believe can be, the same as it is for the corporate world for a variety of reasons, all of which proceed from the basic difference that we are dealing with governments and sovereigns not commercial enterprises. Although commercial enterprises, in many cases, are able to use municipal finance to accomplish their capital raising objectives.

I do not think the SEC should be in the business, as we are with corporate issues, of reviewing mandatory filings from issuers. But what I do think we can do is get some consistency and clarity in accounting. The use of the same accounting standards and independent accounting standards by government issuers would be a big improvement. I think there is no question we can do much better in making what disclosure is available in theory available in practice by letting users have ready access to it. It is hard to find right now.

And I think we can do a lot to conform the presentation so people know where to look for information, where to find it. In these and other respects, there is much that can be done.

Senator ALLARD. So the rules and regulations that you are thinking about will help bring more a clear understanding of what is happening? And your interactive system that you are putting up, that is where you would apply that information? Is that what you are thinking?

Chairman COX. Yes. I also think we can wash a whole lot of cost out of the system. The evidence is that individual investors pay transaction costs that are about 40 percent higher in the municipal area than they do in the corporate area. A lot of that is related to, our economists believe, the fact that the disclosure system for municipals is substandard compared to the corporate system.

Senator ALLARD. Thank you.

On the International Financial Reporting Standards, I may show some ignorance here but we have countries that are more socialistic and actually own part of the company that might be traded. Is that possible?

So then that happens. So when you are applying accounting standards like Sarbanes-Oxley, how do you evaluate a total country's financial standing and actions that they may take that would affect the value of that company? That is my question.

Chairman COX. Well, if it were ever the case that the parent, for securities purposes, were the government and the government was not amenable to conducting its finances in according with our norms, then I think they would not meet the listing standards here.

Senator ALLARD. Is this not one of the dilemmas that you are dealing with when you are talking about an international reporting system or accountability system?

Chairman COX. Well, I think there are many potential issues in this area. We have not had to face them in terms of listed companies specifically in the United States. But when one is talking about what is going on in general in the world's capital markets, the increasing tendency for governments to acquire massive amounts of investable assets and then to take positions with those assets carries with it a great deal of potential for harm to markets. Because markets are premised on the wisdom and the results of the interaction of a multiplicity of individuals with their own interests and evaluations of the profitability or risk potential of an enterprise or an asset.

Senator ALLARD. One more question I want to bring up quickly before my time runs out, the issue of combining the CFTC and the SEC. I know what happens here in the Congress. It ends up being a conflict between the Ag Committee and the Banking Committee.

And now both of them, the financial futures is where this gets real cloudy. It used to be the CFTC was more commodity oriented. Now it is the financial futures is a big part of that.

What is the position of the SEC on this?

Chairman COX. I do not think that the Commission has a formal position on this. The jurisdictional split between the SEC and the CFTC is, of course, legislative and it is one that I was very familiar with as a member. It is also one that I was familiar with working in the executive branch before I came to Congress. It has been around a long time. And one of the reasons it persists you alluded to.

I do not think on the other hand, just speaking personally, that there would be anything but good that would come of rationalizing our approach to not just these two agencies but financial services regulation generally throughout the U.S. Government.

Senator ALLARD. Thank you, Mr. Chairman.

Chairman DODD. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

Chairman Cox, last year I asked you about the status of the New York Stock Exchange application to trade unlisted bonds. The application was finally approved in November, a year and a half after it was submitted. That seemed like an awful long time and there are many more examples of how long it takes to get proposals approved.

What can be done to speed up things at the Market Regulation Division?

Chairman COX. The Director of the Division of Market Regulation, Erik Sirri and I are focused on precisely this, for the reason that the demutualization of the markets and the very competitive nature of being a market in the 21st century has made our practice, not necessarily the legislation but our practice under the legislation of the last many decades somewhat obsolete. We cannot take rule filings, sit on them for a very long time, think about them, and expect that the markets themselves can be competitive when they have to react to one another and, in many cases, to competition that comes from abroad.

And so it is our priority to change that whole process into one that works with the priorities of the 21st Century.

Senator BUNNING. Quicker, I hope.

Chairman COX. And that means faster.

Senator BUNNING. Is there a complicated set of rules and regulations within the SEC that prevent it from being quicker?

Chairman COX. Not really. It is more the norm and the practice that has developed over a long period of time, in part because of the complexity of what is being regulated and all of the unforeseen consequences that might——

Senator BUNNING. Are you saying there are different instruments that are out there that were not out there prior to? And therefore the SEC has more difficulty handling that?

Chairman COX. As I say, I think we are going to be able to do this more quickly than we have in the past because there is a reason, and it is a very important one, to do so. But in explaining why it was that the system developed as it did when you were operating in an environment where the markets were more like regulated utilities, it was just—there was more time to consider all of the facets and so on.

Now there is going to have to be a little bit more for the market to do with itself.

Senator BUNNING. Thank you.

The second question has something to do with individual mortgages that have been packaged into securities are already held by publicly traded entities. How effectively can you track those at the SEC? Or do you?

Chairman COX. Which publicly traded entities? Which kinds are you——

Senator BUNNING. Those that have been—mortgages that have been packaged——

Chairman COX. I understand, securitized mortgages held by whom?

Senator BUNNING. Yes.

Chairman COX. By any public entity?

Senator BUNNING. Yes. In other words, that have a risk involved and some of them a bigger risk than others because of the type of mortgages they are.

Chairman COX. Well, with respect to the registration filings of any publicly traded company——

Senator BUNNING. That is what I am concerned about.

Chairman COX [continuing]. The financial statements and notes thereto have to draw attention to anything that is material. And so if it becomes material to the stability and the going concern aspect of any company that it has got something like this on its balance sheet, then our process of providing comments and surely our process of forcing disclosure about these things should bring it to light.

Senator BUNNING. The reason I asked that question is I asked that question, a similar question, to Chairman Bernanke. And he said we can only go a certain length in overseeing what happens to a mortgage through the bank, what the bank does after the fact. And that is why I asked that individual question. The bank actually sells it to another entity. And that entity is usually a secured type of entity that you are responsible for. So in other words, the regulation of that entity.

Chairman COX. Yes, and then you are taking it one step further and the securitized product ends up as a balance sheet risk for a publicly traded company that——

Senator BUNNING. Yes. I am trying to get to the bottom of where we are going.

Chairman COX. And that piece of it, surely, we are responsible for regulating. The disclosures that we require are absolutely, if the rules are observed, guaranteed to get at that.

Senator BUNNING. Are you concerned about the stability of our markets as lending standards are tightened for buyouts and other corporate borrowing?

Chairman COX. I am sorry?

Senator BUNNING. I will go over it one more time. Are you concerned about the stability of our markets as lending standards are tightened for buyouts and other corporate borrowings?

Chairman COX. Obviously, the credit markets have an impact on the equity markets and on securities trading generally. I do not want to, as the Chairman of the SEC, express concern in the sense that I am evaluating market conditions. But rather I will say simply that that is something that in a variety of ways the SEC keeps track of.

Senator BUNNING. That is as far as you want to go?

Chairman COX. I will go further but I want to make the answer as antiseptic as I can. I do not want to scare anybody.

Senator BUNNING. I do not want you to scare anybody either. I want the markets to do very well.

OK, I will take that as an answer. Thank you.

Go ahead, Mr. Chairman, I am finished.

Chairman DODD. Thank you very much, Senator Bunning.

Let me, if I can, come back. First of all, I want to thank Senator Shelby for raising the issue about the rating agency issue. We were both reading an article here in the Wall Street Journal about how the market is reacting to rating agencies, as well. Some of these stocks have declined of rating agencies. This sort of picks up on where Senator Bunning was talking about to some degree here, and that is there have been those who have raised the issue about where the financing—obviously, the rating agencies are paid by the companies that they are then asked to rate. And there has been some concern expressed about to what extent some of these entities have been contributing rather significantly to the rating agencies and whether or not that has had an influence on their decisions.

But clearly the AAA ratings of these issues are a matter of great concern to us here. I do not know whether we will do an oversight hearing on it or not.

But share with us a little bit more. We passed this law, Senator Shelby actually played a very important role in the legislation that was adopted here giving the SEC additional authority. Do you need more authority in this area? Should we be doing more about this?

Chairman COX. Insofar as the Agency itself is concerned, we are metabolizing all of the change that you have provided. We have adopted a number of rules within the statutory deadline that you gave us to implement the law. We are commencing, including building a professional capacity in New York City for this purpose, our examination function vis-a-vis the NRSROs.

We certainly do not know yet what we are going to learn as a result of all of this, but we are very busy embarking upon it.

Chairman DODD. Keep us posted. I think we would both be interested in knowing very early on if you thought there was some additional authority the SEC needed in this area.

Let me jump, if I can, to these issues. I raised the issue, we have sent a letter, Senator Shelby and I, up to you and Secretary Paulson regarding some of these proposals by the other Committee dealing with regard to taxes on the issue of hedge funds, private equity firms, publicly traded partnerships and the like. I am not going to ask you to comment on tax policy. I realize that is not within your authority. But share with this Committee if you will, do you have any concerns about this at all?

I cannot speak for Senator Shelby. My interest is really I want to know whether or not there are unintended consequences here. As the Chairman of a Committee that has jurisdiction over these matters here, should we be concerned at all about something that could have an adverse effect? And do you believe there are any adverse effects that we ought to be aware of at this juncture?

Chairman COX. You and the Congress have given the SEC the mission of the promotion of capital formation. So we are concerned to that extent. We have provided technical expertise upon request to the tax-writing committees in recent weeks and months to describe how this works from our vantage point, how it might work under proposed legislation.

One of the very general things that I can observe is that if tax legislation discriminates against public companies it is entirely possible that we will have an unintended consequence of fewer public companies and barriers to becoming public, which would itself have an impact, a negative one, on capital formation.

Chairman DODD. Beyond that, any further comments on this?

Chairman COX. Well, I do think there is a line that I should not cross. I was comfortably on the other side of it just a few years ago, where I go to opine on tax policy. But as SEC Chairman, playing my position, I do think you rightly observe that that is not what we should be responsible for.

Chairman DODD. There have been several articles written recently about—let me just state at the outset, I think hedge funds perform a very, very important and valuable role in the capital markets. They have just been a tremendous asset in many, many ways.

But there are some concerns obviously being raised by people. And the President's Working Group—were you a member of the President's Working Group?

Chairman COX. Yes.

Chairman DODD. You were. They determined that any additional regulation was not needed. This goes back now several months ago, to February I think it was. I wonder if, in light of *The Chicago Tribune* wrote a piece recently about the Amaranth Advisors, which again we all recognized while there was a lot of money involved, did not have the impact on the markets that many might have assumed it would.

Yet in San Diego their retirement fund was among those burned and losses in its portfolio were estimated at $100 million. On a large scale that does not seem like much. But if you are talking about the retirement fund in San Diego, it is a big deal, obviously.

Business Week reported that smaller colleges are moving aggressively into hedge funds and identified colleges that had invested 60 to 82 percent of their endowments in hedge funds. They may be putting their endowments in some jeopardy was what one article wrote in Business Week.

I just want to ask you here this morning whether or not you think any additional authority is needed? Do you need additional authority at the SEC? Are there any concerns that have been raised since February that cause you, as the Chairman of the SEC, to feel as though some additional authority may be necessary in this area?

Chairman COX. The pension fund risk that you mentioned is certainly a concern. We have been working with the Department of Labor to try and get at some of the data. The data is not reported in a way that makes it readily accessible.

One of the changes that we hope to be able to accomplish, working with DOL, is to define what a hedge fund is for purposes of data collection and then to start learning in a more rigorous way how these funds that are regulated by DOL are actually invested.

To the extent that we can infer it now, and that is possible through privately researched data as well as Government data, it appears that in the recent past, even though there is a lot of attention and discussion connected with pension fund investment in hedge funds, that the relative amounts, the relative diversification seemed to be respectively small and substantial so that the risk seems all to be on the come. The other thing that we have inferred is that there is a lot of fluidity here and the trend all seems to be in one direction, as your question describes. So I think it is a useful area of inquiry.

We ourselves, as you know, have just adopted a hedge fund anti-fraud rule which will give us a very direct enforcement authority in this area, not so much enlarging upon authority that we never had in the past but rectifying some of the temporary dislocation caused by the Goldstein decision, and also signaling the Commission's intent to focus anti-fraud enforcement in this area.

Chairman DODD. You mentioned, in your prepared testimony you went on at some length and talked about the enforcement areas involving various hedge funds, which made me raise the concern about whether or not additional authority was necessary. But at this juncture here you are telling me the answer is no?

Chairman COX. Certainly in the enforcement area we have all the tools we need.

Chairman DODD. Beyond that, you are in the process of evaluating whether or not more authority would be necessary? Or you are satisfied at this juncture you do not need any additional authority?

Chairman COX. The two concerns that not only the SEC but I think all the members of the President's Working Group and indeed our counterpart regulators overseas persistently have are systemic risk and retailization, investor protection as it were.

I think we have done a lot to address those challenges together since 1999. Market discipline in this area has really, really improved. And managing the credit risk is something that the markets themselves have become much more sophisticated at.

Chairman DODD. Do you buy into the notion here, and again you hear talk about the flight to London and elsewhere here. Obviously it is very much in our interest, this has been a very important part of our economy. We want to maintain our market leadership globally in this area here.

But I get somewhat concerned that some of these arguments here about the flight of industries to foreign capitals here because of regulatory schemes. How do you feel about that? What is your reaction to those things in terms of these rumors or discussions we hear by others about companies fleeing the United States?

Chairman COX. I think the starting point needs to be not the state of U.S. legislation, regulation, litigation or anything else but rather the state of the global capital markets. We have to recognize that there is such a thing, that there is competition from all about the planet, and that there is nothing in nature that requires or commands that financings be done here. There needs to be a competitive reason and an advantage to do so.

The built-in advantage that the United States has is twofold. First, we have a big market and a lot of retail participation that is very different from most other countries. But a big deep pool of capital that is more substantial than anywhere on Earth.

The second thing that we have too is the highest standards on Earth, which anyone investing for the long term knows is vitally important because the way up is very easy but what happens then when things turn sour. The U.S. markets have proven themselves to be remarkably resilient and that long-term capacity of the U.S.

market is our stock in trade. We need to make sure that we do everything possible to protect that.

So I would say that we need constantly to sharpen our competitive edge, constantly scrutinize our regulatory system, make sure that in this world of rapidly changing technology, market mergers across national boundaries and all of the changes that we have seen in financial products that we still serve the needs of the 21st century.

But we also need to make sure that we never, never lose our first principles: investor protection and well regulated markets and the promotion of capital formation.

Chairman DODD. Thank you for that answer.

Senator Shelby.

Senator SHELBY. Chairman Cox, I am glad to hear you reiterate it. You have said this before. The integrity of our capital markets are paramount. We have achieved that by hard work, diligence, oversight, and so forth. And whether it is accounting standards that we talked a little bit about, go right to this, or whether it is bond ratings to by people, it all goes to this.

I wanted to pick up on something Senator Dodd brought up and that is hedge funds. Sitting right here at this table Chairman Greenspan, that we all have a lot of respect for, he has said on many occasions that hedge funds brought liquidity, that is capital, and risk to the marketplace which is a very important part. Chairman Bernanke, I believe, has echoed that here, too.

I think that we have to be careful in over regulating our hedge funds because of what it could do to the market. I know there is risk in the market but there is no market without risk, as I understand it.

I have a couple of areas. I have a number of questions for the record, Mr. Chairman, that I would like to ask Chairman Cox but I have two that I want to——

Chairman DODD. We will do that for all members, by the way, if that is all right. We will make sure in the next couple of days those questions are submitted to you so they do not drag out, but that will be open.

Senator SHELBY. Chairman Cox, the terror web tool. In June the SEC added a web tool to its Internet site, it is my understanding here, that permitted investors to obtain information directly from company disclosure documents about their business interests in countries the U.S. Secretary of State has designated as state sponsors of terrorism. That is Iran, Cuba, Sudan, North Korea, and Syria. It worked by displaying a portion of a company's most recent annual report that discussed business activities in or relating to any of the five state sponsors of terrorism that I mentioned.

In response to concerns expressed by some Members of Congress and some companies on the list, the Commission, it is my understanding, announced last week that it was temporarily suspending the availability of the new program while it "undergoes reconstruction", whatever that means. What is your assessment of the quality of disclosures relating to business activities in the terror states? And what are you trying to get at by the term "reconstruction?"

Chairman COX. Thank you, Senator.

By making it possible for people to look through disclosure documents and find what they are looking for, the SEC just does a better job of serving our mission. There is no question that people wanted to see the portions of company disclosure devoted to their business in states designated by the Department of State as sponsors of terrorism. I say that because the site was up between June 25th and July 16th and it received over 150,000 hits. This is a much more significant level of interest in people's 10–Ks than we have seen for a long time.

The problem is that we have got to screen out not just to the maximum extent possible but just screen out completely any SEC involvement, any human involvement as it were, in qualitatively assessing this information. We want the company's disclosure to speak for itself.

We attempted to accomplish that by making sure that what came up was exactly what the company wrote, without anything else from the SEC. All of the disclosures, in addition, were linked to the full text of the Company's annual report in which this disclosure appeared.

But in order to make the tool work, human beings had to go through and search disclosures to find these things and link them to the tool that you then saw depends on the Internet. And that meant it was hard to keep it up currently. If someone filed an 8–K with more current information, let us say their last year's annual report said we do business in Iran, and subsequently because of investor pressure they left Iran and they filed an 8–K and said so, our tool was not capable of pulling that up. We would have had to wait until their next annual report.

Because of the premium that the SEC places on full, complete, accurate disclosure, we thought it was important to get that tool right or not do it at all.

Senator SHELBY. Thank you. I think it is very important that the public know, that we all know who could be companies who can be aiding and abetting terrorism in countries around the world.

Soft dollars, a question. You recently sent a letter urging the Banking Committee, our Committee here, to ban or substantially restrict the use of soft dollars. The letter asserted that the safe harbor for certain soft dollar arrangements "hurts investors in the U.S. capital markets by protecting arrangements that involve substantial conflicts of interest, may contribute to higher brokerage costs, is difficult to administer, and may operate to impede the further development of efficient markets for brokerage as well as certain advisory services." Your words.

Can you elaborate on the concerns stated in your letter and indicate what steps would need to be taken, either by the Securities and Exchange Commission, or by this Committee and the Congress to address the situation regarding soft dollars?

Chairman COX. Senator, we are focused on the disclosure aspects of soft dollars to the maximum extent that the SEC possesses that authority. But that is really the limit of what we can do, define it, require its disclosure and so on.

To the extent that there are other issues associated with soft dollars, such as the ones that you described and I referred to in my letter, those are properly the purview of the Congress because soft dollars are enshrined in Section 28(e) of the 1934 Act.

It is for that reason that I communicated with this Committee to let you know what we think we can do at the SEC and what we cannot.

Senator SHELBY. And what we can do to help.

Thank you, Mr. Chairman. I do have these questions for the record, that you indicated——

Chairman DODD. We will submit those and we would appreciate it, Mr. Chairman, if you could respond.

I will say to the members who are absent here but to their staffs, if they have additional questions from their members, let us know as quickly as possible.

Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman.

I want to go back to the soft dollars issue, I know that my colleague from Alabama talked about. I have always believed there should be a vibrant independent research industry, well-regulated, to protect investors. So I applauded the steps you took when you first became Chairman to speed up the new process of issuing the new guidance on the appropriate use of the soft dollars which culminated in a unanimous SEC interpretive release in July of 2006.

Soft dollars, as we know, are critical to independent research. And SEC's release was an important first step toward providing clarity on the appropriate use of soft dollar payments because there have been abuses but we do not want to throw out the baby with the bathwater.

But this guidance by itself is not sufficient, as many people have pointed out. Disclosure rules are still necessary. And you acknowledged this when you publicly agreed to create new disclosure rules on soft dollars in the comments you issued contemporaneous with the July 2006 release.

Disclosure rules like these, if well-crafted, would allow fund investors, managers, and boards to see how their commission dollars are spent and evaluate the value of independent research. Under Brandeis's admonition, sunlight is the greatest disinfectant. The rules would be consistent with the authority granted to the SEC under Section 28(e), which governs the use of soft dollar commissions.

Since that time, when everyone thought we were making great progress, we have not heard of any new developments on SEC soft dollar disclosure rules. Instead, you sent, at least in my view, an unexpected—and I think inappropriate—letter when you suggested that legislative intervention to fix the abuses with soft dollars was required. This came as a huge surprise because it was unclear what evidence there was of soft dollar abuses.

I understand you recently received a letter describing that virtually no abuses of soft dollars have occurred in recent years. Since the SEC issued a report on soft dollars in 1998, there have only been three SEC enforcement actions involving client commissions. None of them involved 28(e).

Given all of this, what is the great need here to push comprehensive legislative solutions over the more easily available and more appropriate SEC rules?

With this in mind, I have three questions: and they mirror the questions I sent you a letter on July 20th. I hope you have received it and had a chance to look at it.

First, when do you expect the SEC to issue its disclosure guidance on soft dollar commissions?

Second, as recently as July 2006, you supported new disclosure guidance for soft dollar commissions. Has your view changed since then?

And third, what factors support a need for immediate legislation without first exploring the available options under the SEC's rulemaking authority?

Chairman COX. Taking those questions one, two, three, we are awaiting recommendations from the Division of Investment Management right now to require investment advisers to increase transparency. And our staff is simultaneously looking at NASD recommendations on this, too. But for the reasons that you described, and because of my own priority that I place on this, ASAP is the answer.

Senator SCHUMER. Good. Could not be a better answer.

Chairman COX. Second, no, my view has not changed since 2006 on this.

Senator SCHUMER. Good.

Chairman COX. And third, what is the immediate need for legislation? In one sense, none at all since this is such a hoary problem. But the problem has been around for a long time. So the fact that we have gotten along with it for a while does not mean that it should not be addressed.

The problems that I see are persistent and they are built-in. They start with the fact that this overly complicated approach that is completely a regulatory construct is difficult to administer, probably results in higher brokerage costs for investors, and in any case it induces money managers to direct trades to broker-dealers that offer research that the money manager wants rather then that can best execute the advisory client's transactions. That is just built in to the way it works.

In a purely efficient market where research was prized, then research would be priced according to quality and the efficiency of its production and its availability and timeliness and so on.

We need to do everything possible to promote research. I think we are all square on that objective. Research is vital. The information that makes markets work is what we promote at the SEC. And so anything that would harm research is something that we should not just shy away from but run away from.

I think in posing these questions and describing these problems, I did not presume to have the answers but I simply leave it at the water's edge, as it were, for the SEC because it is not within our statutory——

Senator SCHUMER. Let me ask you this, I mentioned it before. Does the SEC have any knowledge of recent abuses? As best I understand, I have studied the issue and I certainly want to clear up the abuses that we heard about in the past. But as I said, there have only been three enforcement actions, none of them involved 28(e), since 1998.

Are you aware of things that we are not in terms of abuses here with soft dollars in recent years?

Chairman COX. The abuses that have gone on in the past, we hope that we have gotten rid of as a result of our interpretive guidance.

Senator SCHUMER. So what is there a need for legislation?

Chairman COX. People were spending it on carpeting and country club memberships and all this sort of thing.

Now the problem is not abuse that we can go after legally, because it is legal. The problem is what is legal and whether or not that is good. But we are not going to bring an enforcement action against anybody doing something perfectly legal.

Senator SCHUMER. But I still do not quite get why there is a need for legislation when about 6 months ago or a year ago everyone thought the disclosure rules would basically do the job.

Chairman COX. The disclosure rules and whatever we can do further by recommendation from the Division of Investment Management will take us as far as we can go. It will exhaust our capacity to deal with soft dollars at all.

And so it may be that the Congress decides that 28(e) today, in the 21st century, makes just as much sense as it did when we got rid of fixed commissions and it was part of that legislative confluence.

Senator SCHUMER. So you have no specific legislative recommendations to make to the Congress?

Chairman COX. No.

Senator SCHUMER. You are just saying well, if you want to go further you need legislation?

Chairman COX. Exactly.

Senator SCHUMER. You are not taking a position as to whether we do or not?

Chairman COX. I certainly have taken a position on whether you ought to think about it, and I want to be completely deferential beyond that.

Senator SCHUMER. Thank you.

Chairman DODD. Senator.

Senator AKAKA. Mr. Chairman, and Chairman Cox, it is good to see you again here.

Chairman Cox, the SEC undertook an ambitious mutual fund reform agenda in the wake of the mutual fund scandals in 2003. Mutual funds are of particular interest to me because they are an investment vehicle that millions of middle income Americans utilize and provide diversification and professional money management. Mutual funds are what average investors rely on for retirement, savings for their children's college, education, and other financial goals and dreams.

At that time, I worked with Chairman Donaldson on what we called governance and transparency in mutual funds. I have advocated for strengthening the independence of mutual fund boards and improving relevant and meaningful disclosures for investors.

In your statement, Chairman Cox, you mentioned that you are considering making information about funds and the brokers that sell them available at the point-of-sale. In addition, you indicate that the Commission is conducting a thorough review of mutual fund fees and expenses and their disclosure to investors.

My question to you is when do you expect the Commission to move forward on mutual fund governance regulations, point-of-sale disclosures, and fee disclosures?

Chairman COX. Thank you, Senator. Every single one of these is of interest and a priority for the Commission precisely because of the heavy concentration of retail investors in mutual funds and all of the bases of concern and interest that you describe in your question.

The point-of-sale proposal is to the point now where I think the commissioners need to decide among ourselves what exactly we want to go with because the professional staff have just about perfected and or nearly perfected their recommendation to us on that.

Likewise, all of the broader 401(k) disclosure improvements, the simplified prospectus for mutual funds that we discussed, I am hoping that we can tackle this year. That would make it timely as well, to consider what we are going to do with the comments that we most recently received on the economic studies in connection with the mutual fund governance rule.

Senator AKAKA. Will additional statutory authority be needed to ensure that important governance improvements and fee disclosures be implemented?

Chairman COX. I do not believe so, Senator. We are not asking for any at this time.

Senator AKAKA. I am concerned that the Office of Investor Education and Advocacy, an essential part of SEC, has been given additional responsibilities and duties which may hinder financial literacy efforts. This spring the Office of Investor Education was tasked with the initial review of Freedom of Information Act requests. Educating investors and reviewing Freedom of Information Act require very different technical expertise, skills and knowledge.

Why were these responsibilities given to the Office of Investor Education? And what is being done to ensure that the Office of Investor Education can continue to effectively pursue its primary purpose of educating investors?

Chairman COX. Thank you, Senator. It is precisely because I want to place a redoubled emphasis on investor education and investor advocacy that I am making the changes that I announced today in that office. We are directing more resources to it to accomplish those objectives.

The filings and information services responsibilities that you referred to that used to be in the Office of Filings and Information Services, have been redeployed about the Agency. Some of them are going to a new office within the Office of Investor Education and Advocacy that has been completely populated with all necessary resources. So nobody that is working on investor ed will be taken away from that and asked to do something else.

Indeed, as a result of the changes that I announced today, we will for the first time have a Director of the Office of Investor Education, something that has never existed before, who will have as her only responsibility and the people who work for her as their only responsibility investor education.

Up until now the way the formerly named Office of Investor Education and Assistance was comprised, they had to, and the Director in particular had to spread their attentions across a number of priorities, all of them related to individual investors but only some of them education.

Now we will have a very sharp focus on that specific function and more people and more resources with which to discharge that function.

Senator AKAKA. Thank you for your responses.

Mr. Chairman, I have written questions that I will submit.

Chairman DODD. Thank you, Senator Akaka, very, very much.

Senator Menendez, thank you.

Senator MENENDEZ. Thank you, Mr. Chairman, and Chairman Cox for your appearance here today.

Let me ask you, I have two fields that I particularly want to try to focus in on, so if you will work with me to try to get through them. One is on the question of regulation of hedge funds. The other one is about the anti-fraud rule and investor protection.

I am curious and I think I came in on the tail end of Senator Schumer's remarks to you, so I may have missed some of it. But I am curious in the wake of the Goldstein decision, that the SEC has yet settled upon what its policy will be in terms of regulating hedge funds moving forward. Particularly last year, in your appearance before this Committee, you said the SEC would look at how to fill the "gaping hole" left in the wake of the Goldstein decision. Do you think the hole has been filled?

And after the Goldstein decision, which effectively reversed the actions of the SEC that was taken in 2004 to increase regulation of the hedge funds, you said we were once again back to a situation where regulation of hedge funds was "inadequate." Do you still think we are at the inadequate stage? How would you characterize our current approach?

Chairman COX. The Goldstein Court did create a gaping hole. In fact, a number of punctures, as well. We have addressed the punctures through new action letters. We have adjusted our regulatory approach to conform to the decision to get things back to the status quo. And our anti-fraud rule specifically takes advantage of the way the Goldstein Court laid out the legal landscape so that we are not limited to frauds upon a client, as it was narrowly defined for one purpose in that decision. But rather, we have clear authority to limit fraud upon investors of investment pools. That is what our new anti-fraud rule clearly permits us to do.

I am of the view that we have essentially filled the hole created by the decision and also we are in a position now to take advantage of the thousands of registrants that we had under our temporary rule before it was invalidated because the vast majority, by far the lion's share of them, have remained registered with us. And so we are, through our examination and inspection resources, taking advantage of that fact and keeping an eye on the advisers.

Senator MENENDEZ. So are you satisfied? Are you satisfied in terms of the protections as to where you are? Are you satisfied that you have the regulatory powers to ensure the safety and security of investors? Or do you believe that Congress needs to act?

Chairman COX. If we take a snapshot right now, I am comfortable. I think, however——

Senator MENENDEZ. Does comfortable mean satisfied?

Chairman COX. Satisfied. The dynamic character, however, of this market, the questions of liquidity in the roles of private pools of capital that we discussed earlier in this hearing, I think require us constantly to be skeptical and to ask that question.

Senator MENENDEZ. Let me touch upon the anti-fraud rule that was adopted by the Commission on July 11th. I certainly applaud the Commission's efforts to strengthen investor protection.

But I wonder, as I believe some of the commissioners did, whether in fact the rule went far enough. Do you think the rule goes far enough in protecting investors? Are there other gaps that the rule does not address or areas that you are exploring that would go beyond the anti-fraud rule?

Chairman COX. I think the rule does a couple of things. First of all, it is tailored post-Goldstein. Second, it should be understood to signal the intention of the SEC to use its anti-fraud enforcement authority in this area. I think, just as I responded to the last question, I think it remains to be seen where the market itself is going.

Senator MENENDEZ. Do you think the rule does anything beyond current law? How can you explain, for example, how does the rule provide investors additional protection? Doesn't Section 206(4) already prohibit fraudulent, deceptive, or manipulative practices by registered and unregistered investment advisors?

Chairman COX. It gives us no authority beyond what we had pre-Goldstein but it reverses the side effect of the Goldstein decision that the anti-fraud provisions of Sections 206(1) and 206(2) of the Act apply only to clients as the Court defined them, and not to investors in the hedge funds.

So now the rule makes it very clear on its face that the SEC can protect investors in the hedge fund.

Senator MENENDEZ. Let me ask you, are there areas that fall outside of the scope of the rule or the SEC's current authority that you still see as loopholes? For instance, how does the SEC protect investors from losses when negligence on the part of the broker is the cause?

Chairman COX. Our regulation of broker-dealers, I think, permits us to deal directly with that. I would not call that a loophole.

Senator MENENDEZ. You are satisfied that you have the process to pursue against those types of cases?

Chairman COX. Yes.

Senator MENENDEZ. For investors who are the victims of fraud, it seems they are often left without a clear person or entity to blame. Does that seem to be the case?

For example, is there confusion between whether the prime broker or the executing broker is liable?

Chairman COX. I am sure that in some cases, depending on the fact pattern, there could be a lot of complication. And I would even allow, in the realm of all potential hypotheticals, that there are cases in which the complicated fact pattern bring with them complicated legal questions.

I do not know that I am prepared to say that there is, perforce, a loophole without confronting the particular case.

Senator MENENDEZ. I am concerned—and I see my time is up, Mr. Chairman, so if I just may have the indulgence of the Chair for a moment.

I am concerned obviously, I think the Chairman's own—your own statement, Mr. Chairman, about how the market has changed dramatically from what it was to what it is, where half of all Americans are now in some form invested in the market.

I am concerned that we have the investor protections that are necessary. There is always risk. There is always got to be good information that people make judgments on. But at the end of the day, I am concerned that the protections that we should have and need to have in the marketplace are not necessarily there.

So this is why I have explored—I will submit some other questions for the record. This is why I am concerned about it and look forward to hearing more about this from you.

I have one other——

Chairman COX. I am sorry, Senator, and I hope we do not count this against your time. But just quickly I want to say that to the extent that we are concerned about retailization our concern at the SEC is in particular ordinary investors, we are trying to make it very clear that the accredited investor standards, the new ones that we are adopting, screen out the potential for fraud and abuse in that way.

There is a lot about hedge funds that requires a high level of sophistication. And so retailization remains a concern for the SEC.

Senator MENENDEZ. Mr. Chairman, if I may just very briefly, on another question on market data, was it the intention under Regulation NMS, the National Market System, to reduce the total amount of market data that the exchanges distribute to their members? If that is not the case, was the intent to encourage more quoting in the market? I am trying to get a sense of what your purposes were and maybe some unintended consequences.

Chairman COX. For starters, Reg NMS affirmed the consolidation model of data distribution for best price quotations and last sale information. But in contrast, it adopted a primarily market-based approach for data that the SROs distribute individually—for example, the full depth of the markets limit order book—outside of NMS plans.

In the main, we have every interest in promoting a broad distribution of market data and not inhibiting that.

Senator MENENDEZ. So is the intention to encourage more quoting of the market or less?

Chairman COX. Well, I think more.

Senator MENENDEZ. Are you going to be looking at how that regulation is being implemented?

Chairman COX. Yes.

Senator MENENDEZ. Mr. Chairman, I have some other questions on fee-based brokerage and whatnot but I will submit them for the record and look forward to the Chairman's response.

Chairman DODD. Thank you, Senator, very, very much. I have some additional questions, as well. But you have been here for almost three straight hours this morning but you have some indication of the strong interest in a wide range of subjects, Mr. Chairman, before your Commission.

We probably ought to try and do this with maybe a little more frequency so we can cover a lot of ground that is before you.

We thank you very, very much. I think I made it clear at the outset, I have been very impressed, Mr. Chairman, with your leadership at the Commission. There are some matters obviously that we all have some concerns about but you would expect that. But overall, I think there has been good leadership and we thank you for that.

We will ask our colleagues to submit the questions as soon as possible and would hope you might be able to respond as quickly as possible, in turn.

With that, the Committee stands adjourned.

[Whereupon, at 12:15 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT FOR SENATOR JACK REED

Thank you Mr. Chairman for holding this timely hearing on the state of securities markets as we witness significant changes both in our domestic securities markets and markets around the world. In this increasingly globalized financial services market, no institution can remain static. These institutions must continually reevaluate themselves to cope with dynamic and rapid change. We got a sense of this just last week when the SEC approved the merger of NASD and NYSE Regulation into a single-Self Regulatory Organization to modernize and streamline their regulatory functions.

In recent months, the SEC has been addressing a number of regulatory reforms aimed at promoting the continued vibrancy and integrity of U.S. securities markets. I commend the Commission's recent action on Section 404 of Sarbanes-Oxley and I am interested in further monitoring its efforts on the mutual recognition of foreign regulatory regimes, international accounting standards, and delistings.

However, with any new opportunity comes great challenges and it is important that any new undertakings in our regulatory regime result in comparable, if not better, safeguards for investors.

There is a growing concern that systemic risk may be creeping into our financial markets in ways that no one fully appreciates. Risk is being distributed more widely across investors, markets, and borders. However, as The Wall Street Journal pointed out last week, "Because the risk gets spread so widely, regulators can do little but watch and try to reassure everybody it is all under control. . . . A system designed to distribute risk also tends to breed it."

The proliferation of products, such as CDOs, that have not been tested in market downturns; the accumulation of large pools of capital in unregulated, highly leveraged, hedge funds; and accounting rules that do not promote transparency in financial reporting seem to have created a potential for problems that could spill over from the financial markets to the general economy.

Bear Stearns recently announced that two of its hedge funds are now nearly worthless after some of its investments in subprime mortgages went bad; Moody's and Standard and Poor's have significantly downgraded ratings on hundreds of subprime-related bonds; and the ABX index has hit new lows. Portions of the index that tracks especially risky mortgage bonds with junk-grade ratings had been falling, but now these declines are spreading to the portions of the index that track bonds with ratings of AAA or AA. According to Merrill Lynch's latest fund manager survey, 72% of managers said that credit or default risk was the biggest threat to financial market stability.

Furthermore, when I see structured mortgage products that were initially rated AAA at inception trading at prices associated with junk bonds less than one year after issuance, I wonder if there isn't a structural problem with the way credit agencies are doing their work. It is clear to me that a AAA rating obviously doesn't mean what it used to.

These events, combined with the weakness in the markets last week, have brought many new issues to light and raised significant concerns about some of the systemic risks facing our securities markets. I would appreciate hearing about the efforts of the SEC in that regard.

Finally, last week the SEC also issued two distinct proposals regarding proxy access for shareholders.

I am deeply concerned both about the process associated with approving these proposals as well as the proposals themselves. For starters, the issuance of two diametric proposals is unprecedented by the SEC. As Commissioner Nazareth pointed out, by issuing contradictory proposals, the SEC has opened the door the possibility of cherry-picking provisions from each of the proposals that may result in the worst of all worlds.

Additionally, while one of the proposals put out for comment would, in theory, allow shareholders access to proxies. I have serious concern that the 5% threshold included in that proposal would make any subsequent rule meaningless in its application. This threshold would limit the ability of even large, long-term institutional investors, such as CalPERS from having access to shareholder proxies. I hope that the Chairman will elaborate for us on the derivation of 5% as the threshold and direct us to the data the SEC used in setting the threshold at that level.

Clearly, there are many issues that I hope we have an opportunity to discuss this morning. I appreciate your presence here, Mr. Chairman, and I look forward to hearing your thoughts on these matters.

PREPARED STATEMENT OF SENATOR MIKE CRAPO

Our capital markets are at a crossroads and there are major regulatory, tax, and liability questions which need to be addressed in order to ensure that U.S. capital markets remain competitive. The competitiveness of our capital markets has a very significant impact on the health and growth of our economy.

Several recent reports have concluded that American hegemony over global capital markets has been broken. For instance, the City of London has a leadership position in the OTC derivatives markets, and has become a domicile of choice for Hedge Funds.

Although this has resulted from a number of factors, certainly one important factor contributing to this trend is the growth of U.S. regulatory compliance costs and liability risks compared to other developed and respected market centers.

I am very interested in the way that the United Kingdom and Japan have gone to a single regulator, which is more principles based. It seems to me that we could make significant progress in the United States in continuing to have strong customer and investor protection and strengthening our market integrity and achieving effective regulatory compliance but still move toward a more principles based regulatory system.

I look forward to working the members of this committee and we work to bolster the competitiveness of this essential sector of the U.S. economy.

TESTIMONY
OF

CHRISTOPHER COX, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

THE STATE OF THE SECURITIES MARKETS

BEFORE THE
COMMITTEE ON BANKING, HOUSING,
AND URBAN AFFAIRS

UNITED STATES SENATE

JULY 31, 2007

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

Statement of
Christopher Cox
Chairman
U.S. Securities and Exchange Commission

before the

Banking, Housing, and Urban Affairs Committee
United States Senate

July 31, 2007

Chairman Dodd, Senator Shelby and Members of the Committee:

I am pleased to be here today to discuss the important work the Securities and Exchange Commission is doing to protect investors, foster efficient markets, and promote capital formation.

The initiatives underway at the Commission have a common theme: they are aimed at benefiting investors whose returns are dependent on healthy, well-functioning markets. This is the SEC's traditional responsibility. Back in Joseph Kennedy's day, our first SEC Chairman was amazed that "one person in every ten" owned stocks. But today, more than half of all households own securities.

In fact, when one considers the staggering growth in Americans' participation in the markets, the enormity of the SEC's task becomes apparent. About 3,600 staff at the SEC are responsible for overseeing more than 10,000 publicly traded companies, more than 10,000 investment advisers that manage more than $37 trillion in assets, nearly 1,000 fund complexes, 6,000 broker-dealers with 172,000 branches, and the $44 trillion worth of trading conducted each year on America's stock and options exchanges.

Perhaps the most striking development that is underway in our markets is that they are becoming increasingly interconnected with other global markets, and at an accelerating rate. This is challenging the United States and securities regulators around the world to collaborate more closely than ever before. Investors have much to gain in a truly global marketplace, but there are many risks and pitfalls as well. Not only issuers of securities and providers of capital, but fraud artists as well, have gone international.

Vigorous Enforcement of the Securities Laws

Mr. Chairman, many of the issues we face are sometimes trivialized as disputes between business and investors – as if to be pro-investor is to be anti-business, or to be pro-business is to be anti-investor. The truth is, when people invest in a company's securities, they are risking their money on the success of the business. Only if the business succeeds will their investment prosper. That is why the SEC's first Chairman described the SEC's role, and our relationship to business, as a partnership. We take that to mean, today just as back when Joe Kennedy was Chairman, that if a business is investor friendly, the SEC will be friendly to it. But anyone who seeks to drive a wedge between the interests of the business and the interests of the investors in that business will face a relentless and powerful adversary in the Securities and Exchange Commission.

Today, the SEC's Enforcement Division is significantly larger than it was five years ago. Our staff is engaged in combating abuses ranging from boiler rooms and Ponzi schemes to stock option grants to fictitious employees. We are pursuing individuals and firms who have falsified corporate documents, engaged in self-enrichment to the detriment of their investors, and attempted cover-ups of this sort of conduct. We are investigating and filing actions against perpetrators of Internet scams, pump-and-dump schemes, and prime bank frauds, executives who have lied to their auditors, and accountants, lawyers, and other gatekeepers who have joined in the fraud themselves.

The Commission is also making increasing use of the new authority that Congress provided us in the Sarbanes-Oxley Act to use "Fair Funds" to ensure that the penalties and disgorgements that result from the Commission's enforcement efforts are returned to investors as quickly as possible. Through this program we have returned over $2 billion to injured investors. But the Commission recognizes that we can improve on our efforts in this area. To that end, the Commission is developing a considerable expertise in the distribution of Fair Funds and I recently announced our intention to create a dedicated office that will specialize in this area, which should be up and running by October.

And because investors are best protected when securities firms have robust compliance programs that prevent violations, the Commission has taken new steps to help securities firms meet their compliance obligations. Through our CCOutreach Program, we're helping chief compliance officers of mutual funds and investment advisers to implement strong compliance programs for the protection of investors. And, we're making greater use of our website to provide helpful information to securities firms about common deficiencies that we find in examinations, to help them to proactively improve their own compliance programs.

A Record of Accomplishment

The SEC's compliance and enforcement efforts undergird the integrity of the U.S. capital markets. Beyond the SEC's law enforcement and compliance functions, we have undertaken a variety of initiatives and rulemakings to protect investors and increase the efficiency of our rules.

Perhaps the most important step we have taken this year is to improve the implementation of the Sarbanes-Oxley Act ("SOX"), which was enacted five years ago this week. The SEC recently approved new guidance for management in implementing section 404 of the Act. And last week, the Commission voted to approve the PCAOB's new auditing standard, Auditing Standard No. 5, to streamline and improve the audit of a company's internal controls. The new auditing standard and the new management guidance should encourage executives, auditors, directors, and audit committee members to focus on the material risks that investors care about. These actions also represent more than two years of hard work aimed at improving the implementation of 404 for companies of all sizes.

Our SEC guidance to management represents the first time since SOX became law that corporate managers will have guidance intended for its own use in implementing section 404. No longer will the auditing standard be the de facto rulebook for management's compliance with our rules. This guidance should enable cost-effective compliance with 404 for companies of all sizes. Those already complying with our rules can use the guidance to eliminate unnecessary make-work that does little to further the goal of providing reliable financial statements to investors. Those not yet complying (that is, most small companies) can benefit from the lessons learned. For them, the guidance should be a way to avoid wasteful and unnecessary compliance efforts that others have had to endure. Because we have again deferred (for the fourth time) the external audit requirement for smaller companies, management will have a full extra year to develop its own cost-effective compliance approach. It is our intention that this will make it far easier to coordinate a cost-effective external audit when it is first required of smaller public companies in 2009.

When, eventually, smaller companies do come into full compliance, the new auditing standard will allow them to tailor their compliance efforts to their own individual facts and circumstances. The new standard encourages the scaling of all audits. Small companies will be able to apply the guidance to their unique control systems – rather than create costly or complex control systems for the sole purpose of complying with the guidance. By allowing them to tailor the documentation and evaluation approaches to their particular business, we hope to avoid the one-size-fits-all, check-list approach that many larger companies have bristled under as they have tried to comply with 404.

With new guidance that allows management to scale and tailor evaluations to focus on what matters most – and with a new auditing standard that enables auditors to deliver more cost-effective audit services, one final step remains. The SEC and the PCAOB expect a change in the behavior of the individuals who are responsible for following these new procedures. To that end, the PCAOB's inspection program will monitor whether audit firms are implementing the new auditing standard in a cost-effective way that is designed to achieve the intended results. And the SEC, in our oversight capacity, will monitor the effectiveness of the PCAOB's inspections. So both the SEC's and the PCAOB's inspectors will be focused on whether audit firms are achieving the desired audit and cost efficiencies in the implementation of 404. The SEC staff will also conduct an economic analysis – using real-world information – to evaluate whether the costs and benefits of implementing section 404 are in line with our expectations.

These improvements to the implementation of Sarbanes-Oxley are important in the international realm because, while many countries have adopted requirements similar to our internal control assessment in section 404(a) of SOX, ours is the only country that requires an attestation along with the independent auditor's report. This fact has been a source of friction with other markets and with other national regulators and international bodies. The Congress has charged the SEC with making section 404 work both effectively and efficiently and we recognize that doing so will greatly benefit U.S. investors as well as the competitiveness of U.S. companies and financial services providers in the global capital markets.

Just as we are reforming the implementation of section 404 to focus on those areas of highest risk, we have also focused our enforcement, education, and rulemaking efforts on the most vulnerable populations. One manifestation of these efforts is our focus on helping seniors. We organized the first-ever Seniors Summit with our fellow regulators and law enforcement officials and in September will host this year's Seniors Summit, which will integrate even more of our national resources. We are attacking the problem from all angles – from aggressive enforcement efforts, to targeted examinations, rules, and investor education. We have brought 26 enforcement actions during the past year aimed specifically at protecting elderly investors. Many of these were coordinated with state authorities. Another tool in fighting securities fraud against seniors is education. These efforts are aimed not only at seniors, but also their caregivers – as well as pre-retirement workers, who are encouraged to plan for contingencies in later life. The SEC is expanding our efforts to reach out to community organizations, and to enlist their help in educating Americans about investment fraud and abuse that is aimed at seniors. We have also devoted a portion of the SEC website specifically to senior citizens (http://www.sec.gov/investor/seniors.shtml). The site provides links to critical information on investments that are commonly marketed to seniors, and detailed warnings about common scam tactics.

The SEC has also identified the men and women of our military as an at-risk group vulnerable to unscrupulous sales practices for financial and investment products. We have directed our enforcement, examinations, and investor education resources to protecting against these abuses, and we have initiated a coordinated approach with other regulators. We worked with you in the Congress to enact the Military Personnel Financial Services Protection Act just last year, to prevent the sale of potentially abusive insurance and investment products to military personnel.

This week, I am announcing an expansion of the agency's Office of Investor Education and Advocacy. This Office each year has contact with tens of thousands of individual American investors through its investor assistance and education programs. As a result of the knowledge and experience gained through these programs, the Office of Investor Education and Advocacy is able to provide invaluable advice to the Commission on how to advance the interests of America's investors. The Office also plays an important role in the Commission's key initiatives aimed at retail investors – including using "interactive data" to make disclosures more useful to investors, helping senior citizens to guard against securities fraud, and standing up for investors who want disclosures in plain English and easily available on the Internet. Expanding the responsibilities of the Office of Investor Education and Advocacy will help the Commission stay firmly focused on its work to put individual investors first.

The Commission has also updated our rules to facilitate better communications with shareholders and reduce the costs of complying with our regulations. Our recently adopted "electronic proxy" rules will allow shareholders to choose whether to access their proxy materials in paper or electronically. Of course, shareholders who prefer to receive their proxy materials on paper will always be able to do so – and even then they will still have the opportunity to use the proxy materials on the Internet as well. When it comes to interactive data, the shareholders are in the driver's seat.

Building on Our Successes

Just as we are modernizing the SEC's proxy rules, a topic I will touch on further in a moment, we also need to modernize our processes and rules to make maximum use of the benefits of new technology for making the capital markets more easily accessible and understood by investors. Nothing holds more promise for giving ordinary investors the information they need in a timely, useful way than interactive data. New technology that can sort through mountains of SEC-mandated disclosure and turn it into something meaningful holds enormous potential for investors. What we are calling "interactive data" would provide investors in mutual funds, 401(k)s, common stocks and other securities far more useful information than anything they have ever gotten from the SEC before.

The SEC's current online system, known as EDGAR, is really just a vast electronic filing cabinet that does little to exploit the power of today's computers. Sure, it can bring up electronic copies of pieces of paper on your computer screen, but it does not allow you to manage that information in ways that investors commonly need. Interactive data would change that. It would allow any investor to quickly find, for example, the mutual funds with the lowest expense ratios, the companies within an industry that have the highest net income, or the overall trend in their favorite companies' earnings. This is possible through an internationally used computer language called XBRL. The Commission is investing more than $54 million over several years to begin building the infrastructure to support widespread adoption of interactive data. Companies have told us that the substantial benefits of implementing XBRL will exceed the minimal costs. In addition to providing far more useful information to investors, I believe the use of interactive data can make companies' internal processes more efficient, saving investors' dollars for the costs of registration and compliance reporting to the SEC. It would also make the SEC's own disclosure reviews more productive.

We are also hard at work addressing the question of shareholder access to the company's proxy materials – the second time this decade that the Commission has faced this question. The Commission has recently released two very different proposals for comment and thus my comments on these proposals and the issue of shareholder access to the company's proxy materials are my own and do not necessarily represent the views of my fellow Commissioners. Last September, the Second Circuit invalidated the interpretation of Rule 14a-8(i)(8) that a company may exclude from its proxy materials a shareholder proposal that relates to an election for membership on the company's board of directors. Since the effect of the decision is to create uncertainty about the application of Rule 14a-8, the Commission acted. Moreover, the effect of applying the court's decision as a rule of general application would be to permit director election contests without the disclosures required by the election contest rules.

The Commission considered and approved two different proposals in response to this question so that we will have the benefit of the full breadth of commentary about different ways of addressing this important issue. By considering alternatives, we will have the benefit of thorough analysis of a variety of ways to accomplish our stated objectives. This approach will also give us a richer context in which to evaluate public comment concerning the potential costs and benefits of any new rule.

The first proposal would expressly permit the inclusion of shareholder-proposed bylaws regarding shareholder director nominees in the company's proxy materials. This approach would also ensure that shareholders receive the disclosures currently required under the other proxy rules. And it would require important new disclosures about the shareholder or shareholders who are proposing the bylaw – comparable to those required for a proxy contest. The disclosures would be made under the Schedule 13D/G regime, which requires that shareholders who alone or as part of a group own more than five percent of the company's shares provide certain information about themselves. The shareholder proponent or group of proponents would have complete freedom to structure the bylaw, so long as the procedure for director nominations that it sets out complies with applicable state law and the company's charter and bylaws. This would avoid imposing a federal, one-size-fits-all approach, but rather to promote shareholder choice and private ordering.

In addition, the first proposal includes important new features to facilitate greater online interaction among shareholders and between shareholders and management. It would amend the proxy rules to remove obstacles to electronic shareholder communications. It would clarify that a company or shareholder who maintains an electronic shareholder forum is not liable for statements by any other participant in the forum. It would also eliminate any ambiguity concerning whether participation in an electronic shareholder forum could constitute a proxy solicitation, if such participation occurred more than 60 days prior to a shareholders' meeting.

The second proposal would amend Rule 14a-8(i)(8) to clarify the interpretation of the current rule. That approach would ensure that in all proxy contests, shareholders would receive the disclosures currently required under the other proxy rules. And it would permit the exclusion from the company's proxy materials of all shareholder-proposed bylaws concerning director nominations.

Ultimately, empowering shareholders and issuers is the key to keeping U.S. markets competitive, because capital will flow to where it is treated well – with a firm and fair regulatory regime that serves the common interests of investors and business. We are confronting the challenges and opportunities of more foreign listings here in the United States in a number of ways, not least of which is the growing prevalence of IFRS, or International Financial Reporting Standards. The SEC now reviews IFRS financial statements from foreign issuers, as well as U.S. GAAP statements from domestic issuers.

Last week, the Commission voted unanimously to publish a Concept Release for public comment on allowing U.S. issuers, including investment companies, to prepare their financial statements using International Financial Reporting Standards as published by the International Accounting Standards Board. In June, the Commission proposed to eliminate the U.S. GAAP reconciliation requirement for foreign private issuers that file using IFRS as published by the International Accounting Standards Board. We also have been supportive of the international effort to develop a set of standards that is high-quality, comprehensive, and rigorously applied, because of the significant potential benefit of converging these two standards. A truly global set of standards would allow investors to draw better comparisons among investment options. It would also lower costs for investors and issuers, who would no longer have to incur the cost of maintaining and interpreting financial statements using different sets of accounting standards.

The Commission is also exploring the merits of a "mutual recognition" approach to facilitate global market access. Just last month, the Commission hosted a Roundtable on Mutual Recognition, where distinguished representatives of U.S. and foreign exchanges, global and regional broker-dealers, retail and institutional investors, and others shared their views on the possibility of mutual recognition. Although the details of a viable mutual recognition approach are still in the early stages of development, in essence, it would permit foreign exchanges and broker-dealers to provide services and access to U.S. investors, subject to certain conditions, under an abbreviated registration system. This approach would depend on these entities being supervised in a foreign jurisdiction that provides substantially comparable oversight to that in the U.S.

A mutual recognition regime would consider – for example, under what circumstances foreign exchanges could be permitted to place trading screens with U.S. brokers in the U.S. without full registration. Mutual recognition would also consider under what circumstances foreign broker-dealers that are subject to an applicable foreign jurisdiction's regulatory standards could be permitted to have increased access to U.S. investors without need for intermediation by a U.S.-registered broker-dealer. While this approach could reduce frictions associated with cross-border access, it would not address the significantly greater custodial and settlement costs that are incurred today when trading in foreign markets.

Drawing upon the valuable input received at the Roundtable on Mutual Recognition, Commission staff is developing a proposal regarding mutual recognition for Commission consideration. I expect the staff to have completed its initial work by the fall. In essence, the goal is to develop a regulatory approach that strikes a balance between securing the benefits of greater cross-border access to investment opportunities, while vigorously upholding the Commission's mandate to protect investors, foster capital formation, and maintain fair, orderly, and efficient markets.

Meeting the Emerging Challenges of the Modern Securities Markets

In the rapidly globalizing securities market place, the SEC has a responsibility to be ready to respond to new challenges. When events warrant, we have created special working groups within our Enforcement Division to deal with emerging risks such as stock options backdating and microcap fraud. We are paying particular attention to ensuring the fairness of our trading markets in order to maintain investor confidence in those markets. In the past few years, the Commission has brought numerous enforcement actions alleging that hedge fund portfolio managers engaged in insider trading. We have created a hedge fund working group within our Enforcement Division to, among other things, coordinate and enhance our efforts to combat hedge fund insider trading, including by working with other federal law enforcement agencies and self-regulatory organizations.

In March of this year, the Commission filed cases against 14 defendants alleging one of the most pervasive Wall Street insider trading rings since the days of Ivan Boesky and Dennis Levine. We alleged that participants in the scheme included several hedge funds and their portfolio managers. In another recent case, we charged a pharmaceutical company executive and his three sons in a multimillion dollar insider trading scheme. We alleged that the father regularly tipped his sons with confidential information misappropriated from his employer, and that the family created a purported hedge fund to conduct the trading and further obscure their identities. In these and other cases, we have worked side-by-side with criminal authorities that have brought their own cases in connection with the illegal conduct.

We have also brought a number of enforcement actions against hedge funds and their portfolio managers who, we alleged, made millions of dollars by trading illegally on inside information regarding upcoming public announcements of private investment in public equity (PIPE) stock offerings. In addition, the Commission has brought cases against hedge fund managers that we charged with trading on the basis of inside information ahead of mergers and acquisitions.

We have also moved to keep our rules up to date, to ensure that we have the necessary tools to prosecute fraud wherever it may arise. Earlier this month, the Commission voted to adopt a new antifraud rule prohibiting investment advisers to pooled investment vehicles, including hedge funds, from defrauding investors and prospective investors in the funds. The rule responds to a 2006 court decision, Goldstein v. SEC, which created uncertainty about whether the Investment Advisers Act's antifraud provisions protect investors in the hedge fund and not just the fund itself. The rule helps the Commission police this market – to deter misconduct and to call to task those who engage in misconduct.

Another area that has been the focus of significant attention is the municipal securities market. This market is vitally important because of its size and the effect it has on the lives of every individual, and on the business of every company in the United States. There now are more than $2.4 trillion of municipal securities outstanding and last year alone, more than $430 billion of new municipal bonds and notes were issued.

When the federal securities laws were enacted more than 70 years ago, the municipal bond market was relatively small and it was dominated by institutional investors. But today fully 36% of all municipal securities are owned directly by households. And another 33% of the total municipals market is held indirectly through money market funds, mutual funds, and closed-end funds. And despite its reputation as a "buy and hold" market, municipals trading volume at over $6 trillion in 2006 is similar to what we see in the corporate bond market.

While the SEC has antifraud authority – which means that we can come in and clean up municipal messes after the fact – we do not have the authority in the municipal market that we have in the corporate securities market to insist on disclosure of material information to investors at the time the securities are being sold.

Last week, I sent a letter to this Committee offering my view that the best way to address the problems and needs of municipal securities investors in a coherent manner is through legislation designed with the modern realities of today's trading market in mind. Any legislation must keep the need of municipal issuers to have access to capital at the lowest possible cost firmly in mind. And while the regulation of today's highly efficient capital markets for non-municipal issuers offers a blueprint for balancing efficiency and investor protection, the model of full registration and regulation applicable to private companies is not necessary for states and local governments. Instead, legislation could focus on making disclosure information available on a more timely basis – before the sale of municipal securities; mandating municipal issuer use of "generally accepted" governmental accounting standards; requiring or permitting SEC oversight of the independent accounting standards setter, the Governmental Accounting Standards Board; and clarifying the legal responsibilities of issuer officials, underwriters, bond counsel, and other participants in offerings.

As we work to promote a more transparent municipals securities market, we are also interested in promoting transparency in the mutual fund market. Because nearly half of the $3 trillion that Americans have invested through defined contribution plans is in mutual funds, the Commission is hard at work on a simplified, plain English disclosure for mutual funds that would give investors what they need to know, in a form they can use. This new, streamlined disclosure document would provide better information about investment objectives, strategies, risks, and costs. Ideally, that information could be made available online, or in writing – as the investor prefers. We are working with the Department of Labor to make this simplified disclosure available to all 401(k) plan participants invested in mutual funds, because every investor deserves to understand the expenses he or she is being charged and the returns he or she is actually getting. We are also considering making information about funds and the brokers that sell them available at the point of sale.

This is not just a matter of clearer writing, but also of clarifying our regulations concerning mutual fund fees and expenses. So the Commission is conducting a thorough review of mutual fund fees and expenses, and the disclosure of these costs to investors. That review includes an examination of the $12 billion that investors now pay each year in Rule 12b-1 fees. I have also called on Congress to consider the future of the so-called "soft dollars" that brokers receive from mutual funds to pay for things other than executing brokerage transactions.

Finally, the SEC is grappling with how to handle the rising prominence of sovereign wealth funds in the global capital markets. Sovereign wealth funds are government investment vehicles which are funded by foreign exchange assets, and which manage those assets separately from the official reserves of the country's monetary authorities. Sovereign wealth funds are not a new phenomenon, but their recent substantial growth and footprint in the global financial marketplace has been dramatic. Published research has indicated that the total sovereign-wealth funds in the world could reach $12 trillion from the current $2.5 trillion by 2015, and could exceed the total size of the world's official reserves within five years. Today sovereign wealth funds are larger than all the world's hedge funds combined and they are significantly less transparent. These funds are being created with the stated objective of obtaining greater returns on national reserves than those obtained by holding sovereign debt or other traditional investments, albeit with greater exposure to risk. However, the combination of the growing governmental (and potentially political) influence over capital market flows that sovereign wealth funds portend, together with the funds' lack of transparency, presents challenges to a regulatory system premised on free markets, the free flow of information, and investor incentives based on profit and loss. We are working on many of the issues raised by the growth of these funds with others in the U.S. Government through the President's Working Group, and internationally through such groupings such as the Financial Stability Forum, to help ensure that the issues raised by sovereign wealth funds are fully addressed.

Mr. Chairman, this is a necessarily summary description of just some of the most important work underway at the Securities and Exchange Commission. But it is a fair survey of the regulatory and enforcement landscape, and the domestic and international challenges we face in the days ahead.

Thank you for this opportunity to appear before the Committee. I look forward to working with you to meet the needs of our nation's investors, issuers, and markets, and I would be happy to answer any questions you may have.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM CHRISTOPHER COX

Q.1. Last year, the Second Circuit Court of Appeals ruled "that a shareholder proposal that seeks to amend the corporate bylaws to establish a procedure by which shareholder-nominated candidates may be included on the corporate ballot . . . [and] cannot be excluded from corporate proxy materials" under the Commission's shareholder proposal rule. Last week, the Commission issued two proposals regarding shareholder proposals on proxy access, one of which could allow investors to nominate independent directors to corporate boards and one of which would not. Both proposals will be published for public comment. In light of the Court's ruling, will the Commission staff continue its current practice of refusing to issue no-action letters on shareholder proposals for proxy access until the Commission considers public comments and adopts a final rule?

A.1. We fully intend to have final rules in place this fall, in time for the coming proxy season. Accordingly, we do not believe that it will be necessary for the staff to address the situation about which you inquire. As discussed at the open meeting on July 25, in the unlikely event that the Commission has not issued final rules before next proxy season, the staff will continue to analyze requests for no-action relief concerning shareholder proposals to establish procedures for shareholders to include their nominees in company proxy materials in the same manner that it did in the 2006–2007 proxy season. Any no-action request is fact specific and there may be any number of bases on which a company may rely to exclude a proposal. Accordingly, there is no way to predict what response the staff may provide to any specific proposal.

Q.2. Hedge funds have been a tremendous wealth-creation vehicle in our capital markets. However, there are concerns about the potential for investors who lack appropriate sophistication to invest in hedge funds. Recently, the Commission adopted a new anti-fraud rule to protect investors from hedge funds advisers who make false or misleading statements and also proposed to increase the amount of wealth required for a person to be deemed to be an "accredited investor" who can invest in hedge funds. When do you expect the Commission to act on the proposed rule to revise the definition of "accredited investor"?

A.2. The comment period on our rulemaking to revise Regulation D to include a new category of investor—the "accredited natural person," which would be defined to be a natural person who owns at least $2.5 million of investments, closes on October 9, 2007. As part of this rulemaking, we also proposed additional amendments to Regulation D that would affect all issuers offering their securities under Regulation D, and not just hedge funds.

I hope to move quickly on the proposals. Nevertheless, we anticipate that the Commission will receive many insightful comments on the proposals, and particularly on the proposed definition of accredited natural person, which the Commission will fully and carefully evaluate before moving ahead. Accordingly, it is difficult to predict the timing of any action by the Commission on the proposals.

Q.3. The Commission has promulgated new rules which require disclosure of executive compensation. On March 24, 2006, in a speech before the Consumer Federation of America, you stated, "I've often been asked whether all of this will be enough to rein in the abuses of excessive compensation in some companies. And the truth is, we won't know until we try." Since then, public companies have given their shareholders disclosures under the new rules. What are your perceptions about the impact of the new disclosures on executive compensation? What other types of actions might serve "to rein in the abuses of excessive compensation in some companies"?

A.3. The new executive compensation rules were effective in December 2006, and the first disclosures provided under these rules were made in the 2007 proxy season. The Division of Corporation Finance has been reviewing these disclosures and plans to issue a report regarding the new disclosures in the near future. As this is the first year in which disclosures have been provided under these rules, it is too early to tell what impact the rules have had, or ultimately will have, on executive compensation. We are confident, however, that these rules provide investors with clearer, more detailed and more comprehensive disclosure about companies' executive compensation plans, policies and decisions. In terms of what other types of actions might "serve to rein in the abuses of executive compensation in some companies," we believe that, consistent with the underlying purpose of the federal securities laws, the new rules will provide investors with the information that they need in order to assess the appropriateness under state corporate law of the levels and form of executive pay. In addition, strong enforcement efforts where there has been wrongdoing, such as in the options backdating area, will play an important role in reining in abuses. Effective board oversight also will be critical in this area.

Q.4. During this proxy season, a sizeable number of shareholder proposals requested advisory votes on executive cash compensation. What is your analysis of the significance of this type of proposal to investors? Have you been able to identify any impacts of such proposals on executive compensation practices?

A.4. Based upon the large number of no-action requests we received relating to these types of shareholder proposals, it is evident that executive compensation continues to be an area of interest for shareholders. In this regard, we have heard of five shareholder proposals in this area that were approved by shareholders during this past proxy season. Our involvement in the shareholder proposal process is not designed to identify the impact that certain proposals have on companies. However, we continue to monitor changes in companies' disclosures as a result of the new executive compensation rules. The new rules should provide investors with a clearer picture of how companies in which they invest compensate their executives and increase transparency of companies' executive compensation practices.

Q.5. Last week, you sent me a letter urging legislative action relating to the municipal securities. You stated, "I believe that investors in municipal securities . . . deserve the same level of current, high-quality disclosure and protection in the municipal market as they do in other capital markets." What impacts do you predict your recommendations regarding municipal issuer accounting and disclosure standards would have on municipal securities issuers and investors?

A.5. If implemented through legislation, I would expect my recommendations to improve municipal issuer disclosure and accounting standards to the benefit of municipal securities investors, as well as issuers and other market participants. History has shown that capital markets benefit from disclosure. Improved disclosure practices, greater availability of disclosure documents, and more uniform accounting standards should enhance the desirability of investing in this market, and may lower costs to issuers. Clarification of the disclosure responsibilities of market participants could reduce the costs to taxpayers, issuers, and their professional consultants that arise because of today's uncertain liability environment.

Q.6. You have said, "our state partners in securities regulation are doing an outstanding job in this area. We're proud to be their partners" and observed that "the SEC and state regulators have . . . achieved some spectacular results in a number of high profile cases." I share your respect for the good work of State securities regulators. Please describe how this partnership is working. What do you see as the future role of the States in securities regulation?

A.6. The Securities and Exchange Commission has a long history of working together with our state counterparts. We share a common mission—to protect investors. It simply makes sense for regulators to work together and where possible, to leverage our respective resources.

Cooperation between the SEC and the state securities commissions takes many forms. During the past several years, the SEC has granted hundreds of requests from state and local government entities for access to our investigative files. The Commission also has referred thousands of investor complaints to state regulators. Similarly, when appropriate the states forward potential enforcement leads to the SEC for its consideration.

In addition, the SEC and the states take advantage of a number of regularly scheduled joint conferences, panels, and meetings to share information and work together to set enforcement priorities for issues that have both state and federal implications. The Commission also sponsors annual enforcement training for state regulators and criminal authorities.

Specific examples of recent cooperative enforcement efforts with state regulators include:

- A joint investigation involving the SEC's Salt Lake Regional Office, the Utah Division of Securities, the FBI and the local United States Attorney's Office which resulted in an emergency civil action filed by the Commission in an alleged $30 million offering fraud by Novus Technologies;
- A joint investigation by the SEC's Los Angeles Regional Office and the Oregon Department of Consumer and Business Services of Rhodes Econometrics, an investment adviser that allegedly fraudulently raised millions of dollars from individual investors, including many senior citizens. The action resulted in

settled enforcement actions filed by both the SEC and the State of Oregon;

- A joint investigation by the SEC's Boston Regional Office and the Massachusetts Securities Division of Lydia Capital, a Massachusetts-based registered hedge fund adviser whose principals were allegedly misappropriating investor funds from a $33 million hedge fund. Both the Commission and the State of Massachusetts filed enforcement actions against Lydia and its principals;
- A successful enforcement action filed by the Commission's Atlanta Regional Office, with the cooperation of the Georgia Securities Division, against Geoffrey Gish (an alleged $30 million prime bank scheme); and
- An emergency enforcement action filed by the Commission's San Francisco Regional Office, with the cooperation of the California Department of Corporations and the U.S. Attorney's Office for the Eastern District of California, to shut down an alleged $25 million Ponzi scheme that victimized hundreds of seniors and other investors nationwide who bought fractional ownership interests I in life insurance policies. The action was instituted against Donald Neuhaus, his daughter Kimberly Snowden, and their company Secure Investment Services, Inc.

Our examination staff meets regularly with their state counterparts across the country in National and Regional Exam summit meetings to discuss areas of common concern, trends in compliance, priorities in examinations and other issues. One particularly successful joint effort is the Annual Joint Regulatory Training program at which state, SEC and SRO examiners receive training from experienced examiners in each organization about examination strategies and techniques, emerging compliance problems and other issues.

One of the more recent joint initiatives in which the SEC, the states, and the SROs have participated is our effort to protect our nation's seniors from being victimized by promoters of various kinds of investment frauds. This initiative has three major components: aggressive enforcement against those preying on seniors, targeted examinations, and investor education. Progress already has been and continues to be made in all three of these areas.

As mentioned previously, it is critical that the SEC and the states continue to maintain a strong partnership in addressing the enforcement and regulatory challenges confronting our organizations. The Commission remains committed to building on these joint efforts to maximize our respective resources.

Q.7. Last year, at the Banking Committee's hearing on "Stock Options Backdating," we heard testimony from Professor Erik Lie, whose research published in *The Wall Street Journal* led to vigorous enforcement actions. Professor Lie has said his research indicates that "almost 30% of firms that granted options to top executives between 1996 and 2005 manipulated one or more of these grants in some fashion. This amounts to more than 2,000 firms." Please update us on the Commission's investigation involving improper backdating of stock options. What is your reaction to Professor Lie's research, particularly with respect to the number of firms that may have improperly backdated stock options?

A.7. The Commission's Division of Enforcement is currently investigating more than 100 companies related to possible illegal backdating of stock options. The companies are located throughout the country, and include Fortune 500 companies as well as smaller cap issuers. They span multiple industry sectors. As of October 1, 2007, the Commission has filed enforcement actions against seven public companies and 26 former executives (associated with 15 companies) alleging securities law violations in connection with backdating stock options, and parallel criminal charges have been brought against 14 former executives. The executives charged include former CEOs, general counsels, chief financial officers and other accounting personnel, human resources personnel, and a former compensation committee member.

The research of Professor Erik Lie draws information from publicly available data concerning stock option awards to top executives from 1996 through 2005. (Erik Lie and Randall A. Heron, "What fraction of stock option grants to top executives have been backdated or manipulated?" (November 1, 2006).) The research suggests that patterns of potential backdating significantly decreased after 2002, when the Sarbanes-Oxley Act shortened the time for reporting option grants to two business days. While Dr. Lie's data suggest a large number of companies chose grant dates that coincided with low stock prices, whether a particular company engaged in illegal backdating depends on the facts and circumstances of each case.

Q.8. Yesterday marked the five-year anniversary of the enactment of the Sarbanes-Oxley Act. What is your assessment of the impact of the Act on accounting, corporate governance, corporate disclosure and securities recommendations?

A.8. The Act has had its intended effects. It may not be perfect in every respect but the vast majority of its provisions are net contributors to the nation's economic health. Investor confidence has recovered. There is greater corporate accountability. Financial reporting is more reliable and transparent. Auditor oversight is significantly improved.

The success of the Act is highlighted by the fact that many of the tenets of Sarbanes-Oxley have been taken up by regulators in foreign countries. Governments in the major markets around the world have established independent auditor oversight bodies like the PCAOB. Other major capital markets also have recognized the conflicts of interest that some non-audit services create, and the need to place restrictions on these services to improve audit quality. A number of countries have even adopted requirements similar to provisions of Section 404 of the Sarbanes-Oxley Act. Several countries, including the United Kingdom, Australia, and Hong Kong, have adopted a comply-or-explain approach to a management assessment. Japan, France, and Canada all now have legislation or regulations requiring a management assessment of internal controls. Still others, such as Mexico, have corporate governance codes that recommend having a management assessment of internal controls.

Q.9.a. You testified that the Commission is exploring the possibility of mutual recognition of foreign securities regulatory regimes. Such a practice could profoundly impact the protection of U.S. investors, depending on the regime, and raises questions and concerns. This possibility requires cautious and comprehensive analysis of a variety of factors, including a comparison of the resources, rigor, culture and values of the foreign legal, enforcement and examination regulatory schemes with those of the United States. How would the Commission assess whether a foreign securities regulatory regime is comparable to United States regulation?

A.9.a. In determining whether a foreign securities regulatory regime is comparable, the Commission would have to consider both the letter of the law, and how it is applied, particularly the rigor of examination and enforcement. Specifically, assessing comparability would require review of the foreign jurisdiction's regulatory standards, examination efforts and surveillance systems, and enforcement activities. This would entail consultation between the Commission and the foreign regulatory authority to determine areas comparably addressed by the foreign regulatory scheme, and possibly areas in which greater levels of harmonization between the two regulatory regimes would be needed to permit recognition. While the manner in which a foreign securities regulatory regime carries out certain regulatory functions might differ between jurisdictions, the overall regulatory arrangements in a jurisdiction would need to be adequate for the protection of U.S. investors that would be utilizing applicable services before a regime could be found to be comparable.

Q.9.b. How would the Commission assure U.S. investors that they will receive the same degree of protection and transparency when buying a foreign security under a mutual recognition scheme as they receive today?

A.9.b. As noted above, the Commission would need to make a determination regarding whether a foreign regulatory regime is comparable before U.S. investors would be able to buy a security under a mutual recognition scheme. Any mutual recognition regime initially could be limited to certain large U.S. investors, which should be more capable of understanding and bearing the risks of dealing with foreign broker-dealers that are subject to different, though comparable, regulatory requirements. Starting with such investors would also afford the Commission the opportunity to review how mutual recognition works in practice before considering whether to extend it to other U.S. investors. Furthermore, U.S. investors under a mutual recognition regime would be provided with notice before transacting with a foreign broker-dealer and before having orders executed in foreign markets. Moreover, the antifraud provisions of the federal securities laws would remain applicable to all transactions under a mutual recognition approach, including the fair dealing standards that have evolved under these provisions.

Q.10. We understand that the cost of capital in the United States is lower than that of other major markets. Please discuss the significance of this factor for the competitiveness of United States markets.

A.10. The low cost of capital that companies face in the U.S. is a good measure of the competitiveness of U.S. markets. Access to deep and liquid securities markets has long attracted many companies, domestic and foreign, to our markets. There appears to be a strong link between the strength of U.S. regulatory institutions and this ability of companies to raise capital on such favorable terms in the U.S. Strong regulatory institutions promote investor confidence, so that investors are willing to provide capital on relatively favorable terms, which in turn brings companies to our markets for low-cost capital.

According to the Commission's Office of Economic Analysis, the evidence from recent research is consistent with this view. A recent study [1] examines the relation between cost of capital and strength of regulatory institutions in across-section of 40 countries globally. The evidence from this study is that the countries with the lowest costs of capital were also the countries with the strongest regulatory institutions, as reflected in the strength of the legal and regulatory protections for investors. The evidence is that the competitiveness of the U.S. is reflected in both the low cost of capital to companies and its strong regulatory protections for investors.

As financial markets have evolved globally, other countries have tended to strengthen their regulatory and market institutions. To the extent other countries follow the leadership of the U.S. in maintaining strong regulatory institutions, we anticipate a natural narrowing of the gap between the competitive strengths of the U.S., and other markets over time, even while the absolute strength of the U.S. markets remain.

Q.11. In the research on competitiveness, there has been discussion of a premium valuation for stocks listed in the United States markets versus other markets. Please explain whether there is a U.S. listing premium, explain the factors which contribute to such a premium and comment on whether this enhances the competitiveness of U.S. markets.

A.11. Foreign companies that list in the U.S. have historically traded at a premium above comparable companies that did not cross-list. This premium is a good reflection of U.S. market competitiveness, and can be traced to several advantages of cross-listing. Those advantages include the lower cost of capital, greater liquidity, higher level of visibility, and improved governance that companies and their investors may directly and indirectly achieve from the decision to cross-list. Enhancements to U.S. market competitiveness are achieved by strengthening the U.S. regulatory and market institutions that give rise to these advantages of cross-listing. The cross-listing premium is thus not itself an enhancement to competitiveness, but rather a reflection of the competitiveness of U.S. markets and the value they create for investors.

[1] Luzi and Leuz, Christian, "International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?" *Journal of Accounting Research*, Vol. 44, No. 3. (June 2006), pp. 485–531.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM CHRISTOPHER COX

Q.1. The Commission has established a new process for negotiating monetary settlements with investigated entities. It is my understanding that Enforcement Division staff can no longer commence discussions of penalties without prior approval from the Commission. This change followed criticism by some that large corporate fines were essentially penalizing shareholders twice. Can you provide additional information regarding this process and tell the Committee why you made this change?

A.1. As a matter of law and good practice, the Commission is, and always has been, the decision maker on whether to bring an enforcement proceeding and on what terms to settle a case. The Commission is the designated authority and the Commissioners are the ones accountable to the Congress and the public for each enforcement decision.

Against the backdrop of the Commission's over 70-year history, the current process for consideration of enforcement matters at closed meetings allows for more staff discretion and for less Commission oversight than has been the traditional norm. As recently as the 1970s, all cases of all kinds were submitted for Commission consideration prior to the initiation of settlement discussions. The recently initiated pilot procedure, in contrast, applies only to the very small number of corporate penalty cases each year, in which early implementation of the Commission's recent and unanimous penalty guidelines is of exceptional precedential importance. Moreover, the procedure maintains the collaborative process between the Commissioners and the staff—with the staff providing invaluable advice to the Commission, and the Commissioners supplying their views and general settlement guidance to the staff. The procedure does not replace the independent judgment of the SEC staff. Rather, it provides a means for the staff to discuss cases and possible resolutions at a more meaningful point, before the negotiation of the settlement and its terms is concluded.

The pilot program has the following objectives:

- Provide clarity, consistency, and predictability in the imposition of monetary penalties. In January 2006, the Commission unanimously agreed on a statement concerning financial penalties against corporations. With SEC offices across the country handling cases of this type the Commission must work diligently to ensure that these Commission-enforcement principles are applied consistently. Providing horizontal equity in a nationwide program sends a clear message to the markets about the costs of engaging in illegitimate behavior, and the importance of compliance with legal norms.
- Strengthen the Commission's enforcement program. By providing the views and recommendations of the staff to the Commission at a time that settlement negotiations are to begin, the procedure will allow the staff to enter upon those negotiations with the full support of the Commission. When enforcement lawyers in settlement discussions sit across the table from outside counsel, we want them to know they will not be second-guessed by the Commission at a later stage.

- Streamline the settlement process. By shortening final Commission review and approval if the staff reaches a settlement within the guidelines set with the Commissioners, the procedure is intended to make the entire enforcement process speedy and more efficient.
- Maintain fairness to potential defendants and respondents. By providing an opportunity to provide written submissions on potential enforcement actions prior to Commission consideration, the procedure guarantees due process to those who are subject to Commission enforcement action.

Because the pilot procedure takes effect at the end of the normal investigation process, the entirety of the process continues unchanged. The procedure provides the Commission with the benefit of a staff recommendation, and a submission by the subject of an investigation, after a case has been fully developed. If the staff believes it is likely to recommend an enforcement remedy that includes a corporate monetary penalty, the staff first informs the company of a possible proceeding, and provides it with an opportunity to make a written submission about the case and the possibility of monetary penalties (in accordance with section 202.5(c) of Commission rules). The company, as in other cases, is free to choose whether to make a submission. The staff then prepares an enforcement recommendation for the Commission to consider, which will include possible charges, sanctions, monetary penalties, and any written submission by the company.

The Commissioners then have the opportunity to discuss the case with the Enforcement staff, and to learn their views about ranges of outcomes that should be acceptable if the company decides to settle. If the Commissioners agree that an enforcement proceeding seeking a corporate monetary penalty is warranted, the Commission will authorize a proceeding and settlement discussions to reach a settlement consistent with the Commission's theory of the case, within the range of settlement guidelines the

Commissioners have identified. If the staff reaches such a settlement, final Commission approval of it generally will occur on an expedited basis without the need for a further closed meeting. The staff may always return to the Commission to recommend a higher or lower penalty range, or lesser or greater charges or non-monetary sanctions, if their recommendation changes based on new information or a development that occurs during the settlement negotiations.

There are several benefits to this procedure. When the staff presents fully negotiated settlement terms to the Commission for approval, without prior consultation, the Commissioners' exercise of judgment and discretion in determining the appropriate outcome for a case can be limited. Modifying the terms of a fully negotiated settlement can often be challenging. Moreover, when the Commission votes to upset a settlement reached independently by the staff, this could undercut the bargaining power of the staff in the agency's nationwide program in future negotiations. A further disadvantage to reopening completed settlements is that the enforcement process is prolonged and delayed. In these circumstances, potential defendants and their shareholders face new uncertainty, and limited government resources are used inefficiently.

The pilot procedures are not designed to increase or decrease the amount of monetary penalties paid by companies or to make corporate penalty payments more or less frequent. Nevertheless, the pilot program is likely to increase the staff's negotiating leverage because the staff will now be engaging in settlement discussions with the backing of the Commission. Thus, the new approach could lead to superior settlements because the staff will not need to hedge in settlement discussions, wondering whether the Commission will back them up or disagree. Ultimately, this approach should increase investor protection by strengthening the position of the staff to obtain results that the Commission believes are appropriate and by bringing clarity and consistency to the imposition of monetary penalties.

On an ongoing basis, we will evaluate the pilot program to determine whether the objectives set forth above are being achieved. If, as intended, this approach to settlement authorization makes the Commission's enforcement program more effective while preserving fairness to potential defendants, it will be made permanent. If not, it will be redesigned or rejected entirely.

Q.2. A recent decision by the U.S. Court of Appeals for the District of Columbia Circuit, *FPA* v. *SEC*, invalidated a rule adopted by the SEC to define the boundary line between brokerage accounts and investment advisory accounts. Some assert that as a result of the decision, approximately one million accounts that previously were regulated as brokerage accounts could be reclassified as advisory accounts. Could you explain the regulatory implications of this decision, in particular its impact on the role of self-regulatory organizations?

A.2. As a consequence of the court's decision in *FPA* v. *SEC*, broker-dealers offering fee-based brokerage accounts became subject to the Investment Advisers Act of 1940 with respect to those accounts and the client relationship became fully subject to the Advisers Act. Investors holding approximately one million accounts with $300 billion in assets must decide whether they will convert their accounts to fee-based accounts that are subject to the Advisers Act or to commission-based brokerage accounts. Only the Commission, and not FINRA, regulates the activities of broker-dealers with respect to their advisory customers.

Firms are considering how to transition fee-based brokerage accounts to other types of accounts by October 1, 2007. Firms, however, consider the restrictions on an adviser trading as principal (pursuant to section 206(3) of the Advisers Act) to pose a significant impediment to providing fee-based brokerage customers the same services in advisory accounts as those customers received when the accounts were fee-based brokerage accounts. In order to address this impediment in a manner that is consistent with the protection of investors, the Commission recently adopted a temporary conditional exemption from the Advisers Act's principal trading restrictions to enable firms to sell securities to investors out of inventory more easily. The temporary rule will expire on December 31, 2009. The principal trading exemption would also be available for all other nondiscretionary advisory accounts, thus addressing firms' concern that any exemption should not distinguish among accounts.

A key condition for using this principal trading exemption would be that firms must treat these accounts as both advisory and brokerage accounts. The purpose of this condition is to ensure that the sales practice rules applicable to broker-dealers—primarily through FINRA rulemaking—continue to apply. These rules specifically address, among other areas, suitability of securities recommendations, product disclosures, customer communications and advertising, and product sales charges. Therefore, the FPA decision should not have any impact on the role of FINRA during the next two years.

Longer term, the Commission is considering the implications of two separate regulatory regimes—broker-dealer and investment adviser regulation—for the delivery of similar financial services. We are awaiting a report being prepared RAND Corporation comparing how the different regulatory systems that apply to broker-dealers and advisers affect investors (the "RAND Study"). The Commission commissioned a study comparing the levels of protection afforded customers of broker-dealers and investment advisers under the federal securities laws. The Commission will have another opportunity to assess the operation and terms of the rule when it receives the results of the RAND Study, which is expected to be delivered to the Commission no later than December 2007, several months ahead of schedule. The results of the RAND Study are expected to provide an important empirical foundation for the Commission to consider what action to take to improve the way investment advisers and broker-dealers provide financial services to customers. One option then available to the Commission will be making the RAND Study results available to the public and seeking comments on them and their bearing on the terms of this rule.

Q.3. Last year the Banking Committee held a hearing to examine whether shareholder-owned exchanges can effectively manage the conflicts of interest that arise in their role as regulators. Since the hearing, concerns have been raised that exchanges may be improperly benefiting from their access to market data. Can you tell the Committee whether it is permissible for an exchange to use data collected for regulatory purposes in order to create proprietary products? Would you be concerned if an exchange was essentially profiting from this dual role of regulator and publicly traded company?

A.3. The Securities Exchange Act of 1934 sets forth a regulatory model that combines both industry and governmental responsibility, and national securities exchanges have a critical "front-line" responsibility for overseeing their markets. In recent years, many national securities exchanges have demutualized and become shareholder-owned, with a number of them becoming publicly traded entities. As you note, your committee and the Commission have closely examined the new ownership structures of these exchanges, given the potential conflicts that may arise as they have become for-profit entities while maintaining their self-regulatory roles. The Commission is currently considering proposals by several national securities exchanges to establish and charge fees for their real-time, last sale data, as well as proposals relating to information regarding the limit order books of certain exchanges. These proposals have generated significant comment and raise important and complex questions, including the level of fees that a market may charge for a variety of market data products, how those fees should be established, and the Commission's role in reviewing those fees. The Commission considers these issues to be of great importance and is carefully weighing the merits of the proposals, as well as the comments it has received regarding them from interested parties.

Q.4. Last week the Commission considered changes to the federal proxy rules governing shareholder proposals and shareholder communications. The most significant proposed change concerns the question of a shareholder's ability to propose procedures in a company's bylaws for the nomination of directors. As you have noted, two "very different" proposals were adopted, each on a 3–2 vote. The first proposal would codify the Commission staff's interpretation of the election exclusion since 1990, permitting the exclusion from the company's proxy materials of shareholder-proposed bylaws concerning director nominations. The second approach would permit shareholders who own more than five percent of the company's shares to propose bylaws relating to director nominations in the company's proxy materials. Given last year's federal appeals court decision, I understand that you want to have new rules in place for the next proxy season. Is there a way to move forward in a consensus fashion?

A.4. Our starting point on both proposals is the long-standing interpretation of the existing rule under which a proposal by a shareholder to amend the company's bylaws concerning the procedures for election of directors could be excluded by a company from its proxy materials. Pursuant to its authority under the Exchange Act, the agency adopted rules so that shareholders receive full and fair disclosure in connection with proxy contests. A number of Exchange Act rules govern the disclosure required in proxy contests, and allowing the use of current rule 14a–8 to establish procedures for the election of directors would circumvent the proxy contest rules. We all agree that it is of the utmost importance that any rule we adopt gives shareholders full disclosure upon which to make an informed decision on a matter as important as the election of directors. With that basic premise in mind, we will continue to evaluate the available alternatives and take full advantage of the public comments that we receive in response to both proposals when formulating and adopting any final rule.

Q.5. Under the Commodity Futures Modernization Act of 2000, the exchanges supervised by the Commodity Futures Trading Commission operate under a self-certification process for exchange rules. Self-certification permits futures exchanges to respond in a timely fashion to the changing needs of their customers. The Securities and Exchange Commission, in contrast, only approves substantive changes to exchange rules after proposals have gone through an informal negotiation process with Commission staff and a formal public comment period. The informal negotiations are not subject to any time limit and could begin months or even years after a rule is submitted. Is the Commission exploring ways to streamline the exchange rule approval process? If so, when would you expect the Commission to act?

A.5. I have asked the staff to develop a proposal that would permit more SRO trading rules to become immediately effective, and would expect the Commission to consider it later this year. Over the years, the Commission has continued to evaluate and adjust the SRO rule filing process, in a manner consistent with the framework established by the Exchange Act, in response to changes in the financial marketplace, including recent changes to SRO market structure and trading system technology, to ensure that rule proposals are processed efficiently and expeditiously in a manner that facilitates the Commission's oversight of the SRO rule-making process.

National securities exchanges are subject to various requirements under the Securities Exchange Act ("Exchange Act"), including the requirement in Section 19(b) and Rule 19b–4 thereunder to file their proposed rule changes with the Commission, which are published for notice and comment. A proposed rule change may not take effect unless it is thereafter approved by the Commission or is otherwise permitted to become immediately effective under Section 19(b) of the Exchange Act. By providing for Commission review of proposed rule changes and allowing for public notice and comment from interested parties, this requirement is designed to ensure that each exchange carries out the purposes of the Exchange Act and exercises its regulatory authority appropriately.

The Commission has periodically revised the rule filing requirements over the years to meet the changing needs of the exchanges in a competitive financial marketplace, while at the same time maintaining appropriate oversight of the SRO rule-making process. For example, in 1994, the Commission adopted amendments to Rule 19b–4 to allow certain non-controversial filings and minor systems changes to become immediately effective.[2] In 1998, the Commission again amended Rule 19b–4, to allow for the listing and trading of certain derivative securities products without first having to submit a proposed rule change under Section 19(b), which helped speed the introduction of new derivative securities products and, enable exchanges to remain competitive with foreign and OTC derivatives markets.[3] In 2004, the Commission established an electronic filing system for proposed rule changes to improve the rule filing process by eliminating paper submissions.

The staff is once again considering options that the Commission could adopt to streamline the SRO rule filing process, particularly with respect to proposed changes to the trading systems operated by exchanges. The ability of SROs to designate a proposed rule change for immediate effectiveness in compliance with Rule 19b–4 represents the most direct way in which exchanges can expedite their proposed rule changes within the framework established by the Exchange Act, and it is this provision under which the staff is currently considering ways to streamline the rule filing process.

[2] See Securities Exchange Act Release No. 35123 (December 20, 1994), 59 FR 66692 (December 28, 1994).

[3] See Securities Exchange Act Release No. 40761 (December 8, 1998), 63 FR 70952 (December 22, 1998).

Approximately half of the proposed rule changes submitted by SROs in 2005 and 2006 were designated for immediate effectiveness, and the staff is evaluating ways to increase that percentage even further. As SROs increasingly utilize the availability of immediately effective filings, it should proportionately reduce the number of filings that must be approved by the Commission, thereby allowing the Commission to devote more attention to those filings that raise novel issues or warrant closer regulatory scrutiny.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM CHRISTOPHER COX

Q.1. Credit, CDOs, and CLOs: When there are structured mortgage products that were initially rated AAA at inception trading at prices associated with junk bonds less than one year after issuance, it raises the question as to whether there isn't a structural problem with the way credit agencies are doing their work. Is the SEC monitoring this situation, and what is the SEC doing to address this problem?

A.1. In recent months, some have criticized rating agencies for the accuracy of their ratings of certain structured finance products, including residential mortgage-backed securities (RMBS). Critics fault the rating agencies for not taking rating actions sooner on those securities as the performance of underlying assets deteriorated, and for not maintaining appropriate independence from the issuers and underwriters of those securities.

Given recent events in the subprime mortgage and credit markets, the Commission staff has begun a review of NRSRO policies and procedures regarding ratings of RMBS and CDOs, the advisory services they may have provided to underwriters and mortgage originators, their conflicts of interest, disclosures of their rating processes, the agencies' rating performance after issuance, and the meanings of the assigned ratings. As described in the Commission's adopting release in June regarding the NRSRO rules, the Commission is studying whether it would be appropriate to require additional types of performance statistics be disclosed as an alternative, or in addition, to historical default and downgrade rates, which are required to be disclosed under the rules adopted.

Q.2. As a member of the President's Working Group on Financial Markets, is the SEC aware of the amount of existing credit default contracts written on structured products, like MBS and CDOs? In case of a credit event, are you concerned about a situation in which the pay out will far exceed the payments made for these contracts?

A.2. As a preliminary matter, the Commission has very limited authority over credit default swaps. In the Commodity Futures Modernization Act of 2000, Congress specifically prohibited the Commission from promulgating, interpreting, or enforcing rules, or issuing orders of general applicability, in a manner that imposes reporting or recordkeeping requirements, procedures, or standards as prophylactic measures against fraud, manipulation, or insider trading with respect to any security-based swap agreement.

Thus, the Commission has limited ability to monitor the amount of existing credit default swap contracts written on structured products like MBS and CDOs, except those held at broker-dealers or consolidated supervised entities. The Commission has little insight into the overall amount of exposure across the markets. Even if all systemically important dealers were to provide exposure information to a single supervisor, this would only produce the gross exposure. This measure would materially overstate actual exposure and provide few clues regarding the distribution of exposure as many institutions hold contracts that effectively offset the economic risk of other contracts in their portfolios. Of note, many financial contracts, including options, involve potential payouts that exceed the amounts received under the contract. Sophisticated institutions manage the risks of this type of exposure, including those related to CDOs, etc.

Q.3. Are you focused on the potential systemic downsides for financial institutions that have double exposed themselves by writing the default derivatives and owning the CDOs?

A.3. In supervising the systemically important U.S. securities firms, termed consolidated supervised entities ("CSEs"), Commission staff monitors concentration and correlations of risks across various instruments and business areas. Further, Commission requirements ensure that adequate capital is held at the parent company against these risks.

A large financial institution may face potential conflicts when, through its various businesses and client activities, it engages in originating or selling CDOs while also being long the CDO, its underlying assets, or related default protection. Management at the complex financial institutions have processes to identify and review transactions that present conflicts, and utilize procedures, such as information barriers within each subsidiary, to mitigate the legal and compliance risks. Businesses involving CDOs are only one place of many where such conflicts must be actively managed.

Q.4. Can you comment on the current quality of underwriting standards for corporate borrowing and the likeliness of tighter credit in the near term? Are you comfortable that risk is contained and we don't have issues in the CLO market similar to issues in the CDO market? Are CLOs structured to allow you to identify and monitor risks?

A.4. The federal securities laws administered by the Commission are aimed at providing full and fair disclosure to enable investors to make informed investment decisions. The federal securities laws do not regulate corporate borrowings, including the underwriting standards used by banks and other lenders in corporate borrowings. In addition, certain securities offerings can be made without complying with the disclosure requirements of the federal securities laws because an exemption from registration is available.

Sales of collateralized debt obligations and collateralized loan obligations, for instance, are often sold to sophisticated investors in transactions that are not registered with the Commission. Because sales of these securities are typically exempt from registration, the information available to the Commission and the public about these securities and their issuers is limited. It would appear, however, that to the extent that the CDO market and the CLO market are closely tied together and are impacted by the significant contraction in liquidity, concerns about the sub-prime mortgage market may be relevant to, and could impact, both markets.

If a company is required to file periodic reports with the Commission, the company is required to provide narrative disclosure about its borrowings and other liabilities. Such disclosures may include a discussion of liquidity and off-balance sheet arrangements, including any contingent liabilities. Filings made with the Commission are subject to a 17 legal and accounting review and, notwithstanding any exemption from registration, the anti-fraud provisions of the federal securities laws apply to all issuances of securities.

Also, as leveraged lending has become a material business for CSE firms in the last few years, the Commission staff has been focusing on the risk management implications for the systemically important CSE firms of such pipeline businesses. While Commission staff does not opine on the terms of the individual deals negotiated by CSE firms, the CSE program requires and has the tools to determine whether the potential risks presented by activities such as leveraged lending are measured and that adequate capital is held by the parent company for such potential funding obligations.

Q.5. Global Trends: Recent news reports from China and Russia suggest that the governments of those countries may be pressuring accounting firms to step back from financial audits that come into conflict with governmental goals. This is of particular concern given the SEC's ongoing consideration of accepting international financial reporting standards without reconciliation to U.S. GAAP, as well as its recent concept release on allowing U.S. firms to use the international standards. Is the SEC concerned about the issues raised by these instances in Russia and China, namely the ability to ensure that foreign firms will be filing accurate financial statements without government intervention? What steps is the SEC taking to ensure the integrity of information reported to U.S. investors from abroad?

A.5. The Commission's Office of International Affairs promotes investor protection and cross-border securities transactions by advancing international regulatory and enforcement cooperation, promoting the adoption of high regulatory standards worldwide, and formulating technical assistance programs to strengthen the regulatory infrastructure in global securities markets. To these ends, the Commission and the China Securities Regulatory Commission agreed to a bilateral dialogue in 2006.

Currently, foreign private issuers that do not file using U.S. GAAP are required to reconcile local country financial information, which may be reported in accordance with IFRS, to U.S. GAAP. Any financial information that is treated differently in home country accounting standards from U.S. GAAP, including differences resulting from government intervention, would result in a U.S. GAAP reconciling item. As proposed in the Commission's July 2007 Proposing Release, acceptance from foreign private issuers of IFRS financial statements without reconciliation to U.S. GAAP would occur only if the foreign private issuer prepares its financial statements in accordance with the English language version of IFRS as published by the IASB. The auditor also must opine that the financial statements comply with IFRS as published by the IASB. If financial statements are prepared using a deviation from IFRS as published by the IASB (*i.e.,* as a result of government intervention or otherwise), the foreign private issuer would be required to reconcile its financial statements to U.S. GAAP.

The periodic reports of both U.S. issuers and foreign private issuers are subject to the same review process of the Commission's Division of Corporation Finance. As of the end of 2006, five companies filing reports with the Commission indicated that they are incorporated or organized in Russia and eleven indicated that they are incorporated or organized in China. In accordance with the Sarbanes-Oxley Act, the Division of Corporation Finance must review each reporting company at least once every three years. Many companies are reviewed more frequently. The correspondence between the Division and the reporting company is made available to the public on the Commission's EDGAR website. Additionally, the anti-fraud rules apply to all filings with the Commission, and the Commission's Division of Enforcement may investigate management and the auditors of U.S. issuers as well as foreign private issuers.

Auditors of U.S. issuers and foreign private issuers are subject to similar oversight as well. Auditors, whether for U.S. issuers or foreign private issuers, must register with the PCAOB, perform audits of public companies in accordance with PCAOB standards and comply with SEC and PCAOB standards. Registered public accounting firms are required to be inspected by the PCAOB at least triennially and audit firms that provide audit reports to more than 100 issuers must be inspected at least annually.

Q.6. Mutual recognition would involve the SEC permitting certain types of foreign financial intermediaries to provide services to U.S. investors provided those entities are supervised under a regulatory regime substantially comparable to that in the U.S. How will the SEC continually evaluate the regulatory regimes of countries with which they agree to mutual recognition to ensure that those regimes remain comparable to the U.S.? Have you considered a process for derecognition if a country's regime is no longer deemed comparable to that of the U.S.?

A.6. As currently contemplated, the Commission would conduct periodic reviews of the foreign regulatory regimes that have been recognized as comparable to the U.S. Such reviews could be scheduled regularly and would give the Commission an opportunity to reassess the recognized foreign regulatory regime's compliance with all of the requirements and conditions for a comparability finding. The Commission could also conduct intermittent reviews when necessary (for instance, upon a material change to the recognized foreign regime's regulation). Upon the completion of either a periodic or intermittent review, the Commission could either reaffirm its comparability approval or withdraw its comparability approval, if it finds that a foreign regulatory regime is no longer comparable to the U.S. A finding that a foreign regime is no longer comparable would, in turn, provide a basis upon which the Commission could rescind, in an orderly manner, the approval of any exchanges or broker-dealers regulated under that regime that are operating in the U.S. under the mutual recognition framework.

Q.7. Shareholder Access: Would you clarify for us the Commission staff's approach, absent a final rule, to considering no action letters on proxy access proposals?

A.7. As is explained more fully in response to Senator Dodd's question, we intend to adopt final rules this fall, so we do not anticipate that we will be faced with this situation. However, in the event that the Commission does not issue final rules before next proxy season, the staff will, as discussed at the open meeting on July 25, continue to analyze requests for no-action relief concerning shareholder proposals to establish procedures for shareholders to include their nominees in company proxy materials in the same manner that it did in the 2006–2007 proxy season.

Q.8. Approximately how many institutional investors currently sponsor shareowner resolutions? How many of those investors own more than 5% of a company's shares and, therefore, would qualify to submit a proxy access proposal under the SEC's proposal? Has the SEC performed any analysis about how difficult it would be for state and local pension funds to meet the 5% threshold contained in your proxy access proposal?

A.8. For a number of reasons, we are unable to track the number of institutional investors that sponsor shareholder proposals. First, institutional investors—and individual investors for that matter—decide for themselves whether or not to submit a proposal to a company and whether to submit a proposal individually or as a group. Second, investors submit their proposals directly to companies and do not have to notify the Commission of such submissions. Therefore, a shareholder proposal may be submitted by a single institutional investor or by a number of institutional investors co-sponsoring a proposal. Third, the Commission staff gets involved in the shareholder proposal process only when a company seeks a no-action position from the staff to gain assurance that it will not recommend enforcement action if the company omits the proposal from the proxy materials based on one of the exclusions in Rule 14a–8. Occasionally, a shareholder may submit a proposal to a company and then engage in negotiations with the company regarding the proposal. As a result of the negotiations, the shareholder and the company may reach a mutually agreeable solution on the matter resulting in the shareholder withdrawing the proposal and request. In other instances, a company simply may agree to include the shareholder proposal in the company proxy materials. We encourage this type of dialogue between a company and its shareholders.

As to how many institutional investors hold 5% of a company's shares and would be able to submit a proposal for a bylaw amendment regarding director nominations, our proposed rulemaking requests data regarding this threshold and whether an alternate threshold would be more appropriate. In this regard, it is important to note that under the proposed rule, a group of shareholders could join together to meet the 5% threshold. We encourage commenters to respond to our request for comment regarding the appropriate threshold so that we, along with our Office of Economic Analysis, can conduct a thorough analysis regarding the ability of institutional investors, individual) or as a group, to submit a shareholder director nomination bylaw amendment.

Q.9. How many of those investors would have to combine their holdings in order to meet the 5% threshold for filing proxy access resolutions required by your proposal?

A.9. The number of institutional investors that would have to cosponsor a proposal and combine their holdings in order to meet the 5% threshold for filing a proposal for a shareholder director nomination bylaw amendment would depend on a number of factors, including the size of each institution's holdings and the size of the company. Because of these variables it would be difficult to provide an estimate in this regard, even if we were able to track submissions by institutional investors. We are hopeful that we will receive useful comment in this general area, including personal experience by investors and specific data to the extent available.

Q.10. The SEC's proxy access proposal seeks comment on issues relating to precatory shareholder proposals? Do you agree that precatory shareowner proposals have, in a number of cases, led to improvements in corporate governance practices that have benefited investors and the U.S. capital markets? Are you concerned that the SEC's proposal could make it more difficult for shareowners to submit precatory proposals?

A.10. There has been a great deal of discussion in this area following the Commission's roundtables on the proxy process and subsequent rule proposals. We recognize the role that non-binding proposals play in enabling shareholders to advise management and other shareholders of corporate governance and other concerns. The rule proposals do not make any changes to a shareholder's ability to submit non-binding proposals. Rather, the Commission requested public comment on procedures for inclusion of such proposals in company proxy statements, including individualized procedures adopted for a particular company, as well as alternatives to their inclusion in the proxy statement, such as the use of an electronic forum. In considering any rulemaking in the proxy area, we believe that it is important to be respectful of the preeminent role of state law in determining shareholder rights. Therefore, our release requests comment regarding non-binding proposals and whether our proxy rules are properly aligned with, or can be better aligned with, shareholder rights under state law.

Q.11. Most shareowner proposals are issued by state and local pension funds, the ten largest of which combined own less than 4% of the entire U.S. equity market. Has the SEC performed any analysis about how difficult it would be for state and local pension funds to meet the 5% threshold contained in your proxy access proposal?

A.11. The ability of an institutional investor or a group of institutional investors to meet the proposed 5% threshold would depend on the size of the institution's or groups' holdings and the size of the company. We have heard from various interested parties regarding the 5% threshold, and there is both support for, and opposition to, the 5% threshold. We have requested public comment regarding the proposed threshold and are hopeful that the public will provide us with commentary that will enable us to more thoroughly evaluate whether 5% is the appropriate threshold.

Q.12. How many shareowner proposals were submitted by mutual funds during the last proxy season? Isn't it true that if mutual funds fail to support shareowner proposals it will be extremely difficult for other institutional investors to meet the 5% threshold contained in your proxy access proposal?

A.12. We do not have a mechanism for tracking the number of shareholder proposals submitted to companies, so we do not have information regarding the number of proposals that may have been submitted by mutual funds. Our rule proposals are out for public comment and we have heard from interested parties that, absent support from mutual funds, it would be difficult to achieve the proposed 5% threshold; however, others have expressed a contrary view. In this regard, we do not have specific data supporting either point of view, but are hopeful that we will receive comments in this area.

Q.13. Private Equity: There has been a lot of talk in recent weeks about a change in the credit cycle that appears to be occurring, and the impact that change may have on private equity deals in particular. Published reports indicate that in recent weeks, debt offerings for major private equity deals have been delayed or altered because of market conditions. Investors have apparently balked at the terms of these deals, leaving the banks on the hook to the private equity firms that are buying these companies. With so much private equity deal activity in the pipeline, and with banks on the hook for debt offerings of over $200 billion to fund these transactions, would you please comment on the systemic risk that this volume of pending debt poses to the banks, the debt and equity markets, and to the economy overall.

A.13. The systemically important Consolidated Supervised Entities ("CSE") provide significant funding to sponsors of private equity deals, often in the form of loan commitments. The risk faced by the originating institution is that the loans will not be purchased by investors, or an issuance of debt or equity intended to repay a loan will not be successful. In such cases, the loan commitments may fund and then remain on the firm's balance sheet.

Under current market conditions, this has occurred with some deals and may well occur with still others. Securities firms supervised by the Commission as CSEs are required to maintain adequate liquidity at the parent, measured against a stress scenario intended to incorporate those funding demands that would occur during a period of market dislocation. Lending commitments are incorporated into this stress scenario, and represent a significant potential use of funding capacity against which liquidity is held.

Q.14. Conflicts of Interest: Many are concerned about the potential for conflicts of interest in the securities markets. I would ask you to focus in on one particular type of conflict, and that is when the CEO or chairperson of a public company participates in a private equity buyout of his or her company. How do these competing interests get reconciled? The current mechanisms are through fairness opinions, "go shop" provisions, special committees of the board, and shareholder votes. Are these mechanisms sufficient to protect the integrity of the markets? Some commentators have suggested that fairness opinions and special committees are fig leaves, "go shop" periods are too short to allow other potential buyers a real chance to value the company, and that shareholders often have little real choice, and much less information, than insiders and private equity firms on which to base their voting decision. What is your view about these conflicts and how best to ensure that shareholders' interests are protected when the fiduciaries they have entrusted to maximize the value of their shares make an offer to buy their company in concert with private equity?

A.14. The rules and regulations administered by the Commission recognize the potential conflicts that could arise when affiliates of an issuer, including management, participate in an offer to buy an issuer. Therefore, in addition to the disclosures generally required to be made to security holders about a takeover offer, certain specific disclosure requirements exist for affiliated transactions. Those specific disclosure requirements include, among other things, information about whether the issuer and any affiliates reasonably believe the transaction to be fair to the unaffiliated security holders; information about the negotiations and material contacts between the issuer, its affiliates and third parties; the effects of the transaction on the issuer, its affiliates, and unaffiliated shareholders; and the alternative transactions or bidders considered and why any such alternative transactions and bidders were rejected. Any information sent to the security holders of a public company regarding an affiliated takeover offer is required to be filed with the Commission and is subject to staff review.

The Commission and its staff continue to monitor whether the disclosures required by the federal securities laws provide security holders with the information necessary for them to make informed voting and investment decisions. When deemed necessary, the Commission may amend the rules and regulations it administers or advise that new laws be adopted by Congress.

In addition to the Commission's disclosure requirements regarding a proposed affiliated takeover offer, state law imposes duties on issuers and their boards of directors and management when structuring transactions, entering into acquisition agreements and considering whether to advise security holders to approve affiliated transactions. Violations of these duties subject directors to state law liabilities. Whether a special committee of the board is used to consider an affiliated transaction, the board wants to obtain a fairness opinion and certain procedural provisions—such as a "go shop" provision—are included in an acquisition agreement is generally determined by those state law duties and other commercial concerns.

Q.15. An upcoming study by Professors James Westphal and Michael Clement found that executives influence ratings by withholding favors from analysts. According to the study, analysts that were aware of an executive who retaliated for being downgraded by not responding to phone calls or refusing to answer questions 7- were less than half as likely as their peers to downgrade that executive's firm after an earnings report came in 50% below forecasts.

Is the SEC aware of the conflicts outlined in the study and are there additional measures the Commission should take to address such conflicts?

A.15. We are aware of the study by Professors Westphal and Clement. In fact, we contacted Professor Clement in early August and he informed us that he was in the process of revising the paper based on recent feedback from an academic journal.

We believe that issuers should be fair and consistent in determining what level of access to company management should be provided to analysts. We will consider the revised study by Professors Westphal and Clement as we continue our consideration of the impact of issuer retaliation against research analysts.

Q.16. Executive Compensation: Last July, the SEC unanimously adopted new executive compensation disclosure rules. In addition to requiring the disclosure of the total annual compensation for senior corporate officers and directors, the rule requires each company to file a Compensation Discussion and Analysis (CD&A). I would like you to comment on your reaction to the first year disclosures and how would you rate the usefulness of the initial CD&A filings?

A.16. Overall, companies have made a good faith effort to comply with the new rules, including the Compensation Discussion and Analysis, and have provided investors with clearer, more detailed and more comprehensive disclosure about a company's executive compensation plans, policies, and decisions. There have been some instances, including some CD&As, where companies have not provided as complete or clear narrative disclosure as we would have liked to see in response to the new rules. In light of the significant changes required in executive compensation disclosure, however, we were not surprised by this result. Rather, we believe that this has been a learning experience for companies. To assist companies in that process, the Division of Corporation Finance is currently completing a special review project of executive compensation disclosures from the 2007 proxy season. The Division is providing public companies with specific feedback about compliance with the rules that they will be able to use in drafting their next year's proxy disclosures. As a result, we are optimistic that we will see even further improved disclosures next year.

Q.17. Backdating Stock Options: I know that the Commission has been concerned about the practice of backdating stock options. It's my understanding that the Commission has issued sanctions against four companies. Recognizing that there are literally hundreds of companies that could be suspected of backdating stock options and over 250 companies that have been identified as having backdated options, how would you evaluate your ability to investigate and take action against further corporations?

A.17. The Commission's Division of Enforcement is currently investigating more than 100 companies related to possible illegal backdating of stock options. The companies are located throughout the country, and include Fortune 500 companies as well as smaller cap issuers. They span multiple industry sectors. As of October 1, 2007, the Commission has filed enforcement actions against seven public companies and 26 former executives (associated with 15 companies) alleging securities law violations in connection with backdating stock options, and parallel criminal charges have been brought against 14 former executives. The executives charged include former CEOs, general counsels, chief financial officers and other accounting personnel, human resources personnel, and a former compensation committee member.

The Commission also has a variety of information available that makes it harder for lawbreakers to conceal possible illegal stock option grant manipulations by public companies. Among other things, the Commission's new executive compensation rules adopted in July 2006, which have since taken effect, were specifically designed to give investors far better disclosure about every public company's option practices. In addition, since 2002, officers and directors have been required to disclose their option awards within two business days. This requirement, which the SEC adopted in August 2002 to implement Section 403 of the Sarbanes-Oxley Act, has made it more difficult for companies to backdate option grants, and it has also helped to enhance the transparency of companies' option plans and practices.

The Commission has made a significant commitment of resources to address the problem of stock option grant manipulation. As I testified before the Senate Banking Committee last year and to the Senate Financial Services Appropriations Subcommittee in May of this year any additional resources from Congress would be put to good use, and could be used to further strengthen our enforcement program.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CARPER FROM CHRISTOPHER COX

Q.1. Our current bifurcated regulatory system sets up burdensome hurdles to the introduction of new derivatives products. A good example would be the credit default products that both the CME and CBOE recently began to trade. It took the SEC and CFTC 9 months to determine how to approve these products in a way that is consistent with the jurisdiction of both agencies. Meanwhile, Eurex, a European exchange, was able to introduce a competitive product within weeks of announcing its intention to do so. Another example would be the gold-ETF options contracts submitted by the CBOE for SEC approval. In this case, the SEC has not acted on this application for more than two years. Can any steps, short of merger, be taken to improve this process? Should there be a time limit related to rules approval which will ensure that new products can be introduced to the market by a date certain?

A.1. The Commission is keenly aware of the importance to exchanges of being able to begin trading new derivative products in a timely manner. To this end, in 1998, the Commission amended Rule 19b–4 to allow for the listing and trading of certain derivative securities products without first having to submit a proposed rule change under Section 19(b), which helped speed the introduction of new derivative securities products and enable exchanges to remain competitive with foreign and OTC derivatives markets.

The staff has also been considering additional steps to further streamline the process to list and trade new products, including streamlining the process by which exchanges trade new products pursuant to unlisted trading privileges (when new products have already been listed by another exchange) and permitting certain new products-related rule filings to be immediately effective upon filing.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM CHRISTOPHER COX

Q.1.a. Regulation of Hedge Funds: What is the threshold you use to gauge whether or not more regulation of hedge funds is needed? Is there a point where systemic risk could become enough of a concern that either the SEC would take further action or you would urge Congress to do so?

A.1.a. The Commission is part of an ongoing Presidents Working Group ("PWG") process to evaluate the impact of hedge funds on the markets and market participants. The growth of hedge funds and the important role in the markets has clearly influenced this effort. We believe the PWG process is the best way to proceed on this issue.

Q.1.b. Should we be more concerned about systemic risks given that hedge funds constitute a much larger percentage of trading volume?

A.1.b. With regard to potential systemic risks presented by hedge funds, the Commission focuses on the adequacy of capital and risk management at the largest banks and securities firms under its CSE program. Because of this program and its emphasis on risk management at firms that, due to their large size, are of systemic importance, the growing importance of hedge funds, therefore, is a secondary issue.

However, with regard to the potential systemic risks presented by hedge funds themselves, market discipline by creditors, counterparties, and investors is the most effective mechanism for limiting systemic risk. To date, information gathered from CSE firms indicates hedge funds have reduced their exposures in an orderly manner. This reduction of positions (and reduction in trading volume) under current market conditions would appear to reflect discipline by hedge funds.

Q.1.c. You said in response to my questioning that you felt we have essentially filled the hole left by the Goldstein decision. Is there additional action or areas you think still need examining by the SEC? Does the SEC need increased authority? Do you think Congress needs to step in?

A.1.c. The Commission and our staff, as a matter of routine practice, review developments in the securities industry, including those relating to hedge funds and other significant market participants. Recently, we resolved, in a new rule, the uncertainty created by the opinion of the Court of Appeals for the District of Columbia Circuit in *Goldstein* v. *SEC* regarding our authority to bring enforcement actions against hedge fund advisers. The rule, which became effective on September 10, 2007, clarifies our authority to bring enforcement actions where an investor in a hedge fund or other pooled investment vehicle is defrauded by the fund's adviser.

The Commission plans to use the new rule, and the authority already granted to us by Congress, to monitor developments with respect to hedge funds and other significant market participants and to address abuses that warrant further action. We also coordinate with other Federal agencies to monitor hedge fund practices, as well as other industry developments.

The Agreement among the Presidents Working Group and Agency Principals regarding guidelines on Private Pools of Capital was signed earlier this year. That agreement, to which I was a party, recognizes that private pools of capital, such as hedge funds, bring significant benefits to the financial markets. It also endorsed:

- limiting the offering of private pools only to investors with the sophistication to identify, analyze, and bear the risks associated with them; and
- ensuring that investors in those pools obtain accurate and timely historical and ongoing material information.

As you can see, we and our staff have many options for monitoring developments with respect to hedge funds, within the authority already granted to the Commission. To the extent that we were to determine that this authority is inadequate to the task, we would submit to Congress a request for additional authority, as well as a full explanation for why we believe a further grant of authority is warranted.

Q.2.a. Market Data: Before Regulation NMS, the market data revenues allocated to each Exchange were based simply on the number of trades reported by that Exchange. As part of Regulation NMS ("national market system"), the SEC has changed that allocation to be based on quotes and trades. While I understand these changes are still being rolled out, it seems that this change has had some unintended consequences. Would you agree there have been some unintended consequences? Was it the intention of the SEC to reduce the total amount of market data that Exchanges distribute to their members? Can you describe what the intent was?

A.2.a. The market data revenue allocation formula adopted as part of Regulation NMS was designed to address certain weaknesses associated with the previous allocation formulas, including: (1) the absence of any allocation of revenues for the quotations (as opposed to the trade reports) contributed by a self-regulatory organization ("SRO"); (2) an excessive emphasis on the number of trades reported by an SRO that had led to substantial and ongoing distortive trading practices, such as wash sales and trade shredding (the splitting of large trades into multiple 100-share trades); and (3) a disproportionate allocation of revenues for a relatively small number of stocks with extremely high trading volume, with a much smaller allocation to the stocks, typically those issued by smaller companies, with less trading volume.

The market data allocation formula was not adopted with the goal of reducing the amount of market data revenue, but was designed to eliminate the trade shredding and other distortive trade reporting practices associated with the previous allocation formula, and to allocate revenues to the SROs that produced the market data that was most useful to investors. The SEC believes that the formula adopted in Regulation NMS is less subject to any particular type of gaming and distortion because it incorporates a more broad-based measure of the contribution of each SROs' quotes and trades. Generally speaking, the formula allocates revenues among the SROs based on measures of the usefulness to investors of an SROs' trades and quotes in a security. The Commission will continue to monitor the operation of the new formula to asses whether it achieves its goals and would welcome feedback as to its success in that respect, as well as insights into any unintended consequences the new formula may be having.

Q.2.b. In response to my question at the hearing, you said the SEC plans to take another look at how the Regulation NMS is being implemented. Can you provide any details? Is there a timeline for any follow up actions you expect the SEC to take?

A.2.b. The implementation of a number of key rules of Regulation NMS, namely the order protection and fair access rules, has been phased in over the past half year, and Regulation NMS will be completely implemented in early October 2007. During this time, the staff has been working closely with national securities exchanges, broker-dealers, industry trade groups and other market participants to monitor each implementation phase. As part of this effort, the Commission has provided where appropriate a number of tailored exemptions from Regulation NMS, and the staff has provided responses to frequently asked questions regarding the new rules. In addition, Commission staff has been coordinating efforts to review the compliance with Regulation NMS by market participants going forward.

Q.2.c. You also stated at the hearing that the SEC would be ruling on the proposals by the NY Stock Exchange that are pending before the SEC. Is there any timeline for this?

A.2.c. The Commission is currently considering proposals by several national securities exchanges, including NYSE, Nasdaq, and Amex, to establish and charge fees for new proprietary real-time last sale data feeds. In addition, the Commission is also considering a proposal by NYSE Arca to charge fees for ArcaBook, a compilation of all limit orders resident on the NYSE Arca limit order book which is currently free of charge. These market data proposals have generated significant comment and raise important and complex questions, including the level of fees that a market may charge for its proprietary market data products, how those fees should be established, and the Commission's role in reviewing those fees. The Commission expects to act on these proposals in the near future.

Q.3.a. Fee-Based Brokerage: Earlier this year, the D.C. Circuit Court reversed a 2005 SEC rule on fee-based broker-dealer services. Since this court decision will have the effect of changing the broker arrangements for more than a million customers who utilize these services, I would like to hear what the SEC's plans are to address this shift that will occur for these accounts. Is the SEC working on a plan to address this issue through regulations or other action? Can you comment on the SEC's plans? As the October 1 court deadline for enacting these changes is fast approaching, does the SEC plan to release any guidance before then?

A.3.a. We are devoting substantial attention to the difficult issues that have arisen as a result of the Court's decision in *Financial Planning Association* v. *SEC*. As you are aware, we requested a 120-day stay of the ruling, which the Court approved and which expired on October 1, to work with the firms on transition issues and to consider further action by the Commission with respect to the application of the Investment Advisers Act to the affected accounts. I have met with representatives of the brokerage industry, and other members of the Commission's senior staff have had multiple meetings with representatives of all groups affected by the Court decision. We are working hard to arrive at a solution with respect to these accounts that protects investors, facilitates investor choice, and is within our statutory authority.

On September 19, 2007, the Commission approved two rulemaking initiatives addressing the FPA decision. One is a proposal for an interpretive rule under the Investment Advisers Act that would clarify the application of the Advisers Act to certain activities of broker-dealers. The other is a temporary rule that the Commission adopted on an interim final basis that provides investment advisers who also are registered broker-dealers an alternative means of compliance with the principal trading restrictions of Section 206(3) of the Investment Advisers Act.

Q.3.b. I understand the SEC has commissioned a study by the Rand Corporation to determine what additional legislative and regulatory steps may be needed to improve regulation in this area. Can you provide any details on the scope of this report? Do you think that this issue will require legislation?

A.3.b. The results of the study by the RAND Corporation are expected to be delivered to the Commission no later than the end of December 2007, several months ahead of schedule. This study is focusing on the marketing, sale, and delivery of financial products and services to investors by investment advisers and broker-dealers. The results of the study are expected to provide an important empirical foundation for considering improvements in regulatory and legislative rules that date back to the 1930s. One option available to the Commission will be making the RAND Study results available to the public and seeking comments on them.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DOLE FROM CHRISTOPHER COX

Q.1. Many medium to small financial institutions are dedicated to traditional banking services. These banks do not engage in the global and diversified non-banking businesses that the nation's largest banks do. Given the differences between banks and typical non-banking corporations, I ask you whether requiring non-diversified, non-global banks to comply with Section 404 serves the shareholders of these banks and public investors in general? Why should already highly regulated banks be subjected to the additional cost and regulatory burden of Section 404 compliance.

A.1. The importance of having adequate internal controls, which provide reasonable assurance regarding the reliability of financial reporting, is long-recognized and was reinforced back in 1977, under the Foreign Corrupt Practices Act, for companies of all types and sizes. Then, in 1991, in response to a financial institution crisis following many savings and loan association failures, Congress also enacted the Federal Deposit Insurance Corporation Improvement Act. That Act includes an internal control provision that is similar to section 404 of the Sarbanes-Oxley Act.

Neither section 404 nor the SEC's implementing rules prescribe the way in which management must design the necessary controls in order to achieve reliable financial reporting. Instead, the SEC's implementing rules simply require annual disclosures to investors about the effectiveness of a company's internal controls as was mandated by Congress. The only exemption from reporting on internal controls provided for by Congress is for registered investment companies.

It is also noteworthy that smaller, less complex companies, including non-diversified, non-global banks, generally require less complex internal controls than larger, more complex companies. As a result, management of such companies can evaluate the effectiveness of their internal controls with less effort and cost than is required of larger, more complex companies. The SEC's recently adopted interpretive guidance for management and the Public Company Accounting Oversight Board's recently adopted new auditing standard were both specifically developed with this point in mind, so that management assessments and auditor attestations can be tailored to the facts and circumstances of companies of all types and sizes without being unduly burdensome.

Finally, the Commission has on four separate occasions delayed the implementation of section 404 for smaller companies (non-accelerated filers). These extensions have not only allowed time for these smaller companies to more gradually prepare to comply with the requirements of section 404, but these extensions have also allowed smaller companies to benefit from the significant improvements that the Commission and the PCAOB have made to the implementing rules based upon the initial three years of experience with the implementation for larger companies.