

FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2010

TUESDAY, JUNE 2, 2009

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 10:33 a.m., in room SD-138, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.

Present: Senators Durbin, Tester, and Collins.

SECURITIES AND EXCHANGE COMMISSION

STATEMENT OF HON. MARY L. SCHAPIRO, CHAIRMAN

STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. Good morning. I'm pleased to convene this hearing on the fiscal year 2010 funding request for two key Federal regulatory agencies within the jurisdiction of this Appropriations Subcommittee on Financial Services and General Government, the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC).

I also want to welcome my friend and my distinguished Ranking Member Senator Susan Collins. We have worked together in many venues, and I'm glad that we're going to share the responsibilities of this subcommittee.

Joining us today to present testimony on the two budgetary proposals are the Honorable Mary Schapiro, Chairman of the SEC, and the Honorable Gary Gensler, Chairman of the Commodity Futures Trading Commission.

Both of these agencies enjoy unique histories, hold specialized and independent responsibilities and take different approaches to markets that serve different purposes, yet the CFTC and SEC both occupy pivotal positions at the forefront of stimulating and sustaining economic growth and prosperity.

We are enduring an extraordinary set of circumstances in our Nation today. We are beginning to slowly emerge from one of the greatest economic crises in decades. After years of struggle, countless families have lost their hard-earned savings, seen their dreams deferred and even denied.

Some may view the subject matter of this hearing as dry as dust, how much money to give to two Federal agencies, but if you step back for a moment and translate their work into the real world, re-

alize that their oversight and their regulation literally protects the savings and futures of American families and ensures that economies in countries around the world will view our economy and the way we run it with respect to as to whether or not the rule of law is going to be followed.

The unprecedented price volatility of our markets for fiscal commodities, such as energy and grains, has hurt our economy, in addition to the previous mention I made of some of the problems that we've had with savings and the like.

Now perhaps more than ever, we need our markets to function transparently and be insulated from manipulation and unfettered excessive speculation. Much remains to be done to stabilize and sustain our financial system.

Chairman Schapiro and Chairman Gensler each bring vast experience to their new leadership posts in this administration and have undoubtedly identified in their brief tenure ways to improve the way we approach regulating securities and futures markets.

As the subcommittee prepares to make difficult funding decisions, I look forward to hearing about the challenges their agencies will face.

In the interest of time, I am going to ask that the remainder of my statement be made a part of the record so that we will have opportunity for testimony and for questions.

[The statement follows:]

PREPARED STATEMENT OF SENATOR RICHARD J. DURBIN

The CFTC and the SEC enjoy unique histories, hold specialized and independent responsibilities, and take different approaches to markets that serve differing purposes. Yet the CFTC and the SEC both occupy pivotal positions at the forefront of stimulating and sustaining economic growth and prosperity in our country.

Market users, financial investors, and the U.S. economy rely upon vigilant oversight by these two agencies in today's evolving—and often volatile—global marketplace.

We are enduring an extraordinary set of circumstances in America today. We are beginning to slowly emerge from one of the greatest economic crises since the Great Depression. After years of sweat and struggle, countless families have lost their hard-earned savings, seeing their dreams daunted, deferred, and even denied.

When a man named Bernard Madoff can, over the span of 10 or 20 years, lure investors into what has turned out to be a Ponzi scheme, causing many of them to lose millions of dollars, and his wrongdoing goes unnoticed by major regulatory agencies, it is clear more has to be done.

When some of the major ratings agencies that gauge whether a company is doing well basically ignore their responsibility and fail to make accurate reports, everyone loses as a result of it.

The unprecedented price volatility of our markets for physical commodities, such as energy and grains, has hurt our economy. Now—perhaps more than ever—we need our markets to function transparently and insulated from manipulation and unfettered excessive speculation.

The Obama administration recently announced a comprehensive plan to significantly regulate credit default swaps and other over-the-counter derivatives. Exempting these investments from regulation has proven to be a costly mistake—contributing to the \$180 billion taxpayer bailout of AIG, the collapse of Lehman Brothers, and the demise of Bear Stearns.

This proposal will require far more transparency and responsibility from derivatives traders that have long operated in the shadows.

Things are still very fragile. Much remains to be done to stabilize, repair, and sustain our financial system on which we all depend. It will take time to redeem the lost faith of the American people in the government institutions they expected would protect them. But I believe we are moving forward with resolve toward a brighter economic course.

I appreciate the fact that Chairmen Schapiro and Gensler have each accepted President Obama's call to be part of the economic leadership team to help craft a more reliable regulatory framework and guide us to a better future.

Both Chairmen bring vast experience to their new leadership posts in this administration—and have undoubtedly identified, even in their brief tenures, ways to improve the way we approach regulating in the securities and futures markets.

As the subcommittee prepares to make difficult funding decisions for the next fiscal year, I look forward to hearing about the particular challenges their respective agencies face in today's tumultuous economic environment. I welcome their input on how we can best help to address those needs.

Before hearing from our panelists, I'd like briefly outline the missions of these agencies and their budget proposals:

Turning first to the SEC, its three-prong mission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. The SEC is the investor's advocate.

The SEC is responsible for overseeing more than 12,000 publicly traded companies, over 11,300 investment, nearly 8,000 mutual funds with \$9 trillion in assets, fund complexes, 5,500 broker dealers with over 174,000 branches, 10 credit rating agencies, and close to \$44 trillion worth of trading conducted each year on America's stock and option exchanges.

The strength of the American economy and our financial markets depends on investors' confidence in the financial disclosures and statements released by publicly traded companies. Investors expect the SEC to be the vigilant "cop on the beat." Regrettably, in many respects, we let them down. I have faith in Chairman Schapiro's leadership and tenacity to turn things around.

This subcommittee wants to make certain that the SEC has the necessary resources to effectively fulfill its obligatory singular mission: protecting shareholders.

The SEC's budget request for fiscal year 2010 totals \$1.026 billion, an increase of \$8.8 million, or 8.8 percent over the agency's fiscal year 2009 enacted level of \$943 million. This proposed fiscal year 2010 budget would fund 3,692 FTE, just 40 more than the current year funding permits.

Crucial to the SEC's effectiveness is its enforcement authority. Each year the SEC brings hundreds of civil enforcement actions for violations of the securities laws, such as insider trading, accounting fraud, and providing false or misleading information.

Serious, thoughtful questions have been raised about whether the proposed enforcement budget is adequate to keep pace with the growing demands.

Second, the CFTC: The CFTC is charged with protecting the public and market users from manipulation, fraud, and abusive practices. It is also responsible for promoting open, competitive, and financially sound markets for commodity futures.

The CFTC helps ensure that the futures markets are equipped to better perform their vital function in the U.S. economy—providing a mechanism for price discovery and a means of offsetting price risks.

The CFTC's oversight and enforcement mission becomes tangible when you consider that futures prices impact what we pay for the basic necessities of our daily lives: our food, clothing, shelter, fuel in our vehicles, and heat in our homes.

This year—2009—marks the 35th year since the establishment of the Commodity Futures Trading Commission. At the time of its inception in 1974, CFTC's 500 employees were tasked with the mission of ensuring fair practices and honest dealings on the commodity exchanges of America's then-\$500 billion futures industry.

Today it is a \$22 trillion industry that looks vastly different. Yes, the traditional agricultural products like wheat, corn, soybeans, and the proverbial pork bellies are still part of the picture. But the landscape has been remarkably altered and diversified with novel and complex commodities . . . everything from grains to gold, currencies to carbon credits.

In the past decade, trading volume has increased more than ten-fold—reaching well over 3.4 billion trades in 2008, and actively traded contracts have quintupled—from 286 in 1998 to 1,521 in 2008. CFTC oversees \$5 trillion of trades—daily.

Adding to this challenge is a significantly transformed globalized, electronic, and round-the-clock marketplace. Moreover, the emergence of derivatives and hedge funds have altered the regulatory environment.

Layered on this are new authorities added through the 2008 farm bill, coupled with escalating public angst about record energy and agricultural commodity price hikes and fluctuations, and a growing influx of financial funds into the futures markets.

Further complicating the picture are transactions that the CFTC currently has no power to presently regulate—the vast "shadow" world of over-the-counter derivatives—like credit default swaps.

Surprisingly, what hasn't changed is the number of staff. Despite the phenomenal surge in volume and activity, CFTC staffing levels have simply not kept pace. In fact, staffing levels have dropped by over 20 percent. CFTC's workforce—like its predecessor over three decades ago in the agency's fledgling years—presently numbers only 500.

For fiscal year 2010, the President's budget request funding for the CFTC of \$160.6 million. This represents an increase of \$14.6 million—a 10 percent hike—above the fiscal year 2009 enacted level of \$146 million.

Of the \$14.6 million in increased funding for next year, \$7.4 million is slated for increased compensation and benefit costs for a staff of 572; \$0.2 million will be devoted to increased operating costs for information technology modernization, lease of office space, and other services; and \$7.8 million will support the salary and expenses of 38 additional full-time staff.

Last August, I had the opportunity to visit the CFTC's Chicago Regional Office. I met with a group of dedicated staff committed to doing outstanding work under challenging circumstances. I learned first-hand just how thin the staffing is.

The CFTC's Chicago market surveillance staff consisted of 10 economists who conduct daily oversight of each actively traded market and 6 trading specialists who process the daily reports detailing traders' actual positions in each market.

These economists are responsible for surveillance of over 1,250 different commodity futures and option contracts, of which 325 are active, involving 13 different commodity types. The commodities underlying the futures contracts the staff must monitor are highly diverse—including grains, livestock, lumber, currencies, Treasury instruments, equity indexes, single stock future, and dairy. More recently, weather derivatives, real estate indexes, and environmental products such as carbon credits and emission allowances became part of their portfolio.

A single staff economist must cover many markets. For example, one staffer is responsible for 10 grains, one for 90 currencies, and one for the surveillance of over 500 hundred single stock futures. Aside from supervision by the chief of the Chicago surveillance section and Washington, DC supervisory personnel, there is limited redundancy built into the system. As a consequence, each one of those economists is critical.

The six trading specialists maintain an extensive daily data-gathering and verification system by collecting reports from exchanges, futures industry firms, and traders. As our energy debate in Washington throughout the last Congress demonstrated, this data collection is very important to the Commission's oversight and to market transparency.

As I pledged since assuming the Chairmanship of this committee, I am serious about addressing the resource deficiency facing this agency.

I will appreciate hearing from both Chairmen their honest appraisals about the resources they will require to achieve their missions, keep pace with change, and becomes as sophisticated as, if not more so, than the entities they monitor—while responsibly managing taxpayer dollars.

Senator DURBIN. And I now turn it over to my Ranking Republican Member, Senator Collins.

STATEMENT OF SENATOR SUSAN COLLINS

Senator COLLINS. Thank you, Mr. Chairman.

Let me begin by saluting you for your leadership on this subcommittee. I am just delighted to be your new ranking member.

About two decades ago, I spent 5 years in Maine State government as a financial regulator overseeing the bureau of banking, insurance, securities administration, and I have a great personal interest in this area because I know that the decisions made by the SEC and the CFTC do, as you have pointed out, have such an impact not only on our economy but on the daily lives of most American families.

So it's a great honor to serve with you as your ranking member and I very much look forward to working cooperatively with you throughout this Congress.

As we begin to consider the fiscal year 2010 budget requests for the SEC and the CFTC, let me also salute the chairman for his

leadership in securing significant increases for both of these agencies.

Thanks to the work of this subcommittee and the chairman's leadership, the budget for the SEC is now nearly 9 percent above the fiscal year 2007 funding level and the budget for the CFTC is 49 percent above that year.

These increases are extremely important, given that both of these agencies were woefully underfunded for years. I personally believe that they're still underfunded and that more work needs to be done.

I want to congratulate the two chairmen for appearing before our subcommittee today with aggressive agendas for change and reform. I look forward to hearing the details about the budget requests.

As the chairman has indicated, the current economic crisis has left our markets in turmoil and the loss of trillions of dollars of value in these markets has depleted family savings, shuttered small businesses and damaged retirement and pension funds.

I am convinced that we not only need to make sure these two agencies have the resources necessary but that we need to proceed with regulatory reform, as well, in order to restore confidence in our markets and to prevent the root causes of the current financial crisis from springing up once again.

Mr. Chairman, I am going to follow your lead and submit the remainder of my statement, as well, but I am delighted to be joining you to work on these critical issues.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF SENATOR SUSAN COLLINS

Good morning. At this first hearing of our subcommittee, I want to thank you, Chairman Durbin, for your leadership. This Subcommittee has jurisdiction over a diverse group of agencies, many of which have a profound impact on the financial stability of our economy and on the lives of most Americans. So it is an honor to serve with you as Ranking Member of this subcommittee, and I look forward to working cooperatively with you during this Congress.

Mr. Chairman, as we begin to consider the fiscal year 2010 budget requests for the SEC and the CFTC, I want to salute you for your leadership in securing significant increases for both these agencies during your chairmanship of this subcommittee. Thanks to your hard-fought efforts, the budget for the SEC is now 8.9 percent above the fiscal year 2007 funding level, and the budget for the CFTC is 49 percent above the fiscal year 2007 level. These increases were extremely important, given that both of these agencies had been woefully underfunded over the years.

Chairman Schapiro and Chairman Gensler: Congratulations and thank you both for appearing before our subcommittee today. I look forward to hearing the details of your fiscal year 2010 budget requests and the key efforts that you plan to undertake this year. You both have crucial roles in our economy: SEC, by protecting the public through enforcement of securities laws, and CFTC, by protecting market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options.

Protecting investors is more compelling than ever since many first-time investors have turned to the markets to help secure their retirements, pay for homes, and send their children to college.

Our current economic crisis has left our markets in turmoil. The loss of trillions of dollars in value in these markets has depleted family savings, shuttered small businesses, and damaged retirement and pensions funds.

Chairman Schapiro, I am troubled by reports that an environment of lax oversight and enforcement at the SEC was a contributing factor to the current financial crisis. For example, some investment banks were allowed to become over-extended, which

led to the collapse of several of Wall Street's largest banks. The Bernard Madoff ponzi scheme went undetected for decades, resulting in \$50 billion in investor losses. So Madam Chairman, I am pleased that you have developed an ambitious agenda of management reforms for the Commission, and I am interested in hearing what resources you need to accomplish these reforms.

Chairman Schapiro and Chairman Gensler: You both have challenging tasks in front of you. You must improve transparency in our securities markets and uncover fraud and deception, while not over-regulating our markets and hindering our economic recovery. I look forward to working with both of you, and with Chairman Durbin to ensure that you have the resources and the tools you need to ensure investors are protected and that markets are functioning properly.

I look forward to your testimony and I thank you for your service to our Country. Thank you, Mr. Chairman.

Senator DURBIN. Thanks a lot, Senator Collins.

Senator Tester, would you like to make an opening statement?

Senator TESTER. Thank you, Mr. Chairman.

Just to welcome Mary and Gary to the subcommittee today. I appreciate the work that you have done and I appreciate the work you are about to do. I think it's critically important that we have good, solid, reasonable enforcement and I think both of you are up to that challenge.

So with that, we'll move on. Thank you, Mr. Chairman.

Senator DURBIN. Thank you, Senator Tester.

Chairman Schapiro, the floor is yours.

Ms. SCHAPIRO. Chairman Durbin, Ranking Member Collins, and Senator Tester, thank you very much for the opportunity to testify today.

In the short time that I've been at the SEC, we have taken on an active agenda, all with the goal of protecting investors, revitalizing the agency, and restoring confidence in the markets. We are making great strides, yet recognize that we have quite a distance to go.

In the area of enforcement, we have changed our policies so that our investigators do not have to jump over unnecessary hurdles before seeking penalties or launching investigations. We have hired a former Federal prosecutor to lead the Enforcement Division, someone who is focused on bringing significant cases with a meaningful impact as quickly as possible and ensuring that the Division is appropriately organized to do just that.

We have begun to update our management systems, to upgrade our risk assessment capabilities so that we can better detect fraud, and we have expanded and improved upon our training so that our staff will be able to keep pace with the new financial products and strategies created on Wall Street.

Already we are seeing results. Since the end of January, as compared with the same period last year, we have filed nearly three times as many temporary restraining order cases, issued more than twice as many formal orders and opened over 20 percent more investigations into fraud.

Although enforcement is central, it is still just one part of our agency. As you know, we are tasked with overseeing broker-dealers, investment advisors, and mutual funds, and we are taking steps to improve our ability to do just that.

For instance, we are working on a risk-based initiative to improve our oversight methods so that we can better identify and focus resources on riskier institutions. We also are recruiting senior

professionals with new skill sets, such as trading, risk assessment and financial analysis, and we have created an Industry and Risk Management Fellows Program to bring top talent into the agency.

SEC'S RULEMAKING AGENDA

In addition to internal management directives, we also have engaged in an active rulemaking agenda. Last month, the SEC proposed significant changes to the rules governing investment advisors who maintain custody of their clients' assets.

Should the proposals be adopted, advisors with custody will have to undergo a surprise exam by an independent public accountant once a year to verify client assets and any custodian affiliated with an advisor would also be subject to custody controls reviews by an independent accountant. The goal is to expose Ponzi schemes and other frauds earlier.

In the area of short selling, the Commission unanimously voted to propose two distinct approaches to limit short selling. One would impose a permanent market-wide short sell price test, the other approach would impose temporary short selling restrictions upon individual securities during periods of severe price declines.

Later this month, the SEC will consider proposals to strengthen the money market fund regulatory regime. We will focus on tightening credit quality, maturity and liquidity standards for money market funds.

We're also exploring whether more fundamental changes are necessary, such as converting money market funds to a floating rate net asset value to better prevent abuses and avoid runs on the funds.

Additionally, I have asked the staff to undertake a comprehensive review of rule 12(b)(1) which allows mutual funds to use fund assets to compensate broker-dealers and other intermediaries for distribution and servicing expenses.

In the area of proxy access, the Commission already has proposed rules that would enhance the ability of shareholders to nominate company directors and next month we will take up a broad packet of corporate disclosure improvements around compensation policies, the use of compensation consultants, and the interplay between risk-taking and incentive arrangements.

But there is still more to do in the regulatory arena. We have been working closely with other Federal agencies to bring the unregulated world of credit default swaps into the sunlight.

Operating under the limitations of the current legislative structure, we recently issued temporary orders to facilitate the establishment of central counterparties for clearing credit default swaps.

In the coming months, we will also tackle issues related to municipal market reform, stock lending, trading in non-transparent markets or dark pools, and hedge fund oversight. I look forward to working with Congress on these issues.

RESOURCES NEEDED FOR SEC'S MISSION

The financial crisis has reminded us all just how large, complex and critical to our economy the securities markets have become. At the SEC, our 3,700-person staff now oversees more than 35,000 registrants, including about 12,000 public companies, 8,000 mutual

funds, 11,000 advisors, and 5,000 broker-dealers, and it is a number that is growing rapidly.

Nonetheless, during this same period the SEC's resources have fallen. Between 2005 and 2007, the agency saw 3 years of flat or declining budgets and lost 10 percent of its employees. This has an impact.

With support from this subcommittee during the last 2 fiscal years, the SEC has been able to lift its hiring freeze and begin rebuilding its workforce, and I am very grateful for that support.

But even with these important steps, the number of staff remains below the levels of only a few years ago. I believe additional resources are essential to restoring the SEC as a vigorous and effective regulator.

The President has requested a total of just over \$1 billion for the agency in fiscal year 2010, a 7 percent increase over this year's level. This budget request would permit us to fully fund an additional 50 staff positions over 2008 levels. These positions would help the SEC's Enforcement Program enhance its pursuit of tips and complaints and fully fund our new Fellows Program that brings in seasoned industry professionals.

In addition to expanding our workforce, the President's request also would enable us to invest more in new technology, a budget item that has dropped by more than one-half in the last 4 years.

Mr. Chairman, I came to the SEC to shape public policy in the interest of investors and to strengthen our Enforcement Program. The measures I have described today are important to those efforts, but what I have also discovered is that we cannot neglect the internal operations of the agency, the processes that guide our work and the agency's infrastructure.

I am committed to a complete review of the internal operations to ensure that we meet the highest standards and that we are fully supporting the important work of our employees. To ensure that we do it right, I intend to bring in a chief operating officer to manage that process.

I want to thank you for your continued strong support of the SEC and its critical mission. I believe that by strengthening our Enforcement Program, enhancing risk-based oversight, and leveraging technology, we can restore investors' confidence in both the SEC and in our Nation's securities markets.

PREPARED STATEMENT

I look forward to answering your questions. Thank you.

Senator DURBIN. Thanks, Chairman Schapiro.

[The statement follows:]

PREPARED STATEMENT OF MARY L. SCHAPIRO

Chairman Durbin, Ranking Member Collins, Members of the Subcommittee, thank you for the opportunity to testify today. I sincerely appreciate the support this Subcommittee has shown the Securities and Exchange Commission, and I am pleased to have the opportunity to discuss with you the Commission's role in helping to address the financial crisis, and to discuss reforms to improve investor protection and restore confidence in our markets.

The last year has been a wrenching time for the investors whom the SEC is charged with protecting. Trillions of dollars in wealth have been destroyed during the economic downturn, and millions of Americans have seen their retirement nest eggs and college tuition funds shrink dramatically as a result. The economic crisis

has challenged faith in our system of capital formation and allocation—a system that has proved over the long term to be the greatest for creating wealth the world has seen.

As an agency charged with protecting investors, maintaining fair, orderly and efficient markets, and facilitating capital formation, we are dedicated to understanding and learning from recent events and from the causes that were building in the system over the years, so that we can do our part to restore market integrity and investor confidence. The SEC must act promptly, decisively, and with resolve. We also must have a renewed commitment to protecting investors; they provide the capital used to fund the productive enterprises that create jobs and wealth. While we have a tripartite mission at the SEC, investor protection is the foundation upon which all our responsibilities are built.

To that end, I've already announced several changes at the agency that will reinforce our focus on investor protection and market integrity and redirect our energies toward restoring investor confidence.

REINVIGORATING SEC ENFORCEMENT

One of my very first actions as Chairman was to end the 2-year “penalty pilot” program, which had required the Enforcement staff to obtain a special set of approvals from the Commission in cases where the staff sought fines against public companies that violated the law. Some enforcement staff had complained that the procedures unnecessarily delayed the prosecution of cases, and discouraged the staff from either seeking a penalty or seeking an appropriately high penalty. At a time when the SEC needs to send a clear message that corporate wrongdoing will not be tolerated, and penalties for securities violations will be stiff, the penalty pilot program was an unnecessary hurdle to more active enforcement.

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

In addition, I have hired a new enforcement director, a longtime Federal prosecutor who served as Chief of the Southern District of New York's Securities and Commodities Fraud Task Force, charged with focusing our enforcement efforts on bringing meaningful, high impact cases quickly. We are working together on management reforms—including harnessing technology, improving risk assessment, and improving training and supervision for our line law enforcement personnel—so that we can maximize our resources to combat fraud and wrongdoing in our markets. Our Division of Enforcement has been working diligently. Since the end of January,

—We have filed at least 34 emergency temporary restraining orders. During roughly the same period last year, we filed 12.

—We have opened more than 358 investigations. During roughly the same period last year, we opened 292.

—The Commission has issued at least 188 formal orders. During roughly the same period last year, the Commission issued 74.

Since January, we have brought a number of important and complex cases. For example, in the Reserve Fund matter filed in May, we charged certain operators of the Reserve Primary Fund, a \$62 billion money market fund whose net asset value fell below \$1.00 or “broke the buck” last fall, with fraud for failing to provide key material facts to investors and trustees about the Fund's vulnerability as Lehman Brothers Holding, Inc., sought bankruptcy protection. As part of this action, we are seeking to bring about an expedited, efficient, and equitable pro-rata distribution to shareholders of the Fund's remaining assets, including \$3.5 billion originally set aside in the Fund's litigation reserve.¹ We believe this will help Reserve Fund investors recover a larger share of their assets.

In March, we initiated a case alleging fraud in connection with a kickback scheme involving New York's largest pension fund. Namely, we charged New York's former Deputy Comptroller and a top political advisor with extracting kickbacks from investment management firms seeking to manage the assets of the New York State Common Retirement Fund. Since March, we have amended the complaint to add additional defendants, including a former New York State political party leader, a

¹SEC v. *Reserve Management Company, Inc., et al.*, Lit. Rel. No. 21025 (May 5, 2009).

former hedge fund manager, a Dallas-based investment management firm and one of its founding principals, and a Los Angeles-based “finder.”²

As committed as we are to vigorous enforcement of the securities laws, we are also mindful that the complexity of 21st century markets, as well as the varied nature of frauds and scams, require that the sophistication and tools available to our Enforcement and Examination programs keep pace. Important questions have been raised concerning the agency’s handling of tips or whistleblower information related in particular to the activities of Bernard Madoff. Clearly this is something we must learn from, and I am committed to addressing it. Former Chairman Cox asked the SEC Inspector General to look into what happened, what failed to happen, and to report back to the Commission. We expect to receive the IG report this summer and will promptly take all appropriate actions and address any remaining shortcomings.

It is clear that, regardless of any findings of the Inspector General, the agency must improve its ability to process and pursue appropriately the hundreds of thousands of tips and referrals it receives annually. In February, we retained the Center for Enterprise Modernization which began work immediately on a comprehensive review of internal procedures to evaluate tips, complaints, and referrals. We are in the process of creating a system that will centralize this information so we can track it, analyze it and more effectively identify valuable leads for potential enforcement action and compliance exams.

STRENGTHENING EXAMINATION AND OVERSIGHT

In addition to these changes, it is essential that we work to improve our risk-based oversight of broker-dealers, investment advisers and mutual funds. Our Office of Compliance Inspections and Examinations (OCIE), together with other agency staff in the Office of Risk Assessment, are presently working on an initiative to identify the key data points that would facilitate an improved risk-based oversight methodology to allow the staff to identify and focus on those firms presenting the most risk. OCIE has improved training and, under a newly authorized program, 268 examiners are now participating in the training and certification program offered by the Association of Certified Fraud Examiners, to identify the warning signs and red flags that indicate evidence of fraud and fraud risk. OCIE is also recruiting additional individuals with experience in different facets of the industry, such as trading, risk assessment and compliance. These steps taken together will expand the knowledge base of our inspections staff, better enabling them to conduct oversight of complex trading strategies and products that exist in our markets today.

I have also launched an Industry and Markets Fellows Program in our Office of Risk Assessment. Through this program, we have begun recruiting fellows with extensive experience in such areas as equity and fixed income securities trading, structured products, complex derivatives, financial analysis and valuation, fund management, investment banking and financial services operations.

IMPROVING TRANSPARENCY AND INVESTOR PROTECTION

The agency is working hard in other areas as well. In the area of accounting standards, the SEC staff completed a congressionally-mandated study of fair value accounting. The staff issued guidance to financial institutions so that they can give fuller disclosure to investors, particularly with respect to hard-to-value assets. The staff has also continued to work closely with the Financial Accounting Standards Board to deal with such issues as consolidation of off-balance sheet liabilities, the application of fair value standards to inactive markets and the accounting treatment of bank support for money market funds. FASB recently took steps to clarify treatment of off-balance sheet items in a manner designed to increase market transparency.

In the area of combating false rumors and manipulative activity in the marketplace, the agency initiated examinations of the effectiveness of broker-dealers’ and investment advisers’ controls to prevent the spreading of false information. When concluded, the results of these examinations will be used by regulators to assist firms in crafting and implementing robust policies and procedures to prevent the spreading of false information.

In the wake of recent Ponzi schemes and other investment adviser abuses, the Commission last month proposed significant changes to the custody requirements for investment advisers. These proposals focus on the value of an independent public accountant serving as another set of eyes to better assure the safekeeping of investor assets. One proposal would require all advisers with custody or control of client

²*SEC v. Henry Morris, et al.*, Lit. Rel. No. 20963 (March 19, 2009), Lit. Rel. No. 21001 (April 15, 2009), Lit. Rel. No. 21018 (April 30, 2009); Lit. Rel. No. 21036 (May 12, 2009).

assets to engage an independent public accountant to conduct an annual “surprise exam” to verify those assets exist. A second proposal would apply only to investment advisers whose client assets are not held by a firm independent of the adviser. In such cases, the investment adviser would be required to be subject to a review that results in a written report—prepared by a PCAOB-registered and inspected accounting firm—that, among other things, describes the controls in place relating to custodial services, tests the operating effectiveness of those controls and provides the results of those tests. These reports are commonly known as SAS-70 reports. The reports would include an opinion of an independent public accountant issued in accordance with the standards of the PCAOB, which will provide an important level of quality control over the accountants performing this review. In addition, advisers would be required to publicly disclose the name of the accountant conducting these reviews, so that our staff can better monitor compliance and assess adviser compliance risks. Accountants also would be required to disclose the reason for any termination or resignation from performing these reviews, which should highlight any “red flags” for regulators and investors.

At my request, our staff is also developing investor-oriented enhancements to the municipal securities area. It is time for those who buy the municipal securities that are critical to State and local funding initiatives to have access to improved quality, quantity and timeliness of information. On a related note, so called “pay-to-play” practices by investment advisers to public pension plans must be curtailed. I have asked the staff to revisit the Commission’s 1999 proposal to address harmful pay-to-play practices, and I expect that the Commission will consider that proposal this summer.

COMBATING ABUSIVE SHORT-SELLING

In my brief tenure as Chairman, the issue of short selling has outpaced any other in terms of the number of inquiries, suggestions and expressions of concern we have received. On April 8, 2009, the Commission unanimously voted to propose two distinct approaches to short selling restrictions. One approach would impose a permanent, market-wide short sale price test, while the other would impose temporary short selling restrictions upon individual securities during periods of severe declines in the prices of those securities. On May 5, 2009, the Commission held a public roundtable to solicit the views of investors, issuers, financial services firms, self-regulatory organizations and the academic community on key aspects of these proposals. The Commission is committed to conducting a thoughtful, deliberative process to determine what is in the best interests of investors, including examining a variety of trading and market related practices such as securities lending.

We also recognize that strong rules and vigorous enforcement are needed to curb abusive short selling and restore confidence in our markets. The Commission has been focused on the issue of abusive “naked” short selling since before my arrival in late January, and the Commission’s regulatory actions have led to a significant decline in failures to deliver securities on time following a short sale. Moreover, our Division of Enforcement has a number of active investigations involving potentially abusive short selling in a variety of contexts.

FILLING REGULATORY GAPS

In an effort towards bringing the unregulated world of credit default swaps into the sunlight, the Commission, working in close consultation with the Board of Governors of the Federal Reserve System and the Commodity Futures Trading Commission (“CFTC”) and operating under the limitations of the current legislative structure, recently issued temporary orders to facilitate the establishment of central counterparties for clearing credit default swaps (“CDS”) by LCH.Clearnet Ltd., ICE US Trust LLC, and Chicago Mercantile Exchange Inc. The Commission is committed to increasing investor protection and reducing systemic risk by facilitating the development and oversight of central counterparties to clear CDS.

We have also been working with the CFTC and Treasury Department to fill regulatory gaps in this area to help increase transparency and minimize risks associated with certain derivative products, including CDS, as well as market participants transacting in these products. I look forward to working with Congress to make the necessary legislative changes to ensure that these markets and market participants are appropriately regulated.

In addition, we are closely examining the broker-dealer and investment adviser regulatory regimes and assessing how they can best be harmonized and improved for the benefit of investors. Many investors do not recognize the differences in standards of conduct applicable to broker-dealers and investment advisers. It is essential that comparable and effective protections be afforded to investors, whether they

turn to a broker-dealer or an investment adviser for assistance in accessing the securities markets.

Finally, hedge funds and other unregulated private pools of capital have flown under the radar for far too long. We are currently examining whether these funds, their managers or both should be subject to SEC registration and oversight, so that investors, regulators and the marketplace have more complete and meaningful information about the funds and their market activities. I look forward to working with Congress on this important issue.

STRENGTHENING SHAREHOLDER RIGHTS

We have launched an agenda of proxy reforms with a proposal approved by the Commission for public comment that would significantly support shareholders' rights to nominate company directors. Next month we will take up a broad package of corporate disclosure improvements, all designed to provide shareholders with important information about their company's key policies, procedures and practices, including compensation policies and incentive arrangements. With this additional information, shareholders will be better able to hold directors accountable for the decisions that they make. For example, the Commission will consider proposals to enhance disclosure of director nominee experience, qualifications and skills, so that shareholders can make more informed voting decisions. The Commission will also consider proposed disclosures to shareholders about why a board has chosen its particular leadership structure (whether that structure includes an independent chair or combines the positions of CEO and chair), so that shareholders can better evaluate board performance. Also, shareholders should understand how compensation structures and practices drive an executive's risk-taking. The Commission will be considering whether greater disclosure is needed about how a company—and the company's board in particular—manages risks, both generally and in the context of compensation. The Commission will also consider whether greater disclosure is needed about a company's overall compensation approach, beyond decisions with respect only to the highest paid officers, as well as about compensation consultant conflicts of interests.

IMPROVING MONEY MARKET AND MUTUAL FUND REGULATION

Later this month, the SEC will consider proposals to strengthen the money market fund regulatory regime. The proposals will focus on tightening the credit quality, maturity and liquidity standards for money market funds to better protect investors and make money market funds more resilient to risks in the short-term securities markets, like those that unfolded last fall. In addition, we are exploring whether more fundamental changes are necessary, such as converting money market funds to a floating rate net asset value, in order to protect investors from abuses and runs on the funds.

In addition, on June 18, the SEC and the Department of Labor will hold a joint hearing on target date funds. Target date funds and other similar investment options are investment products that allocate their investments among various asset classes and automatically shift that allocation to more conservative investments as a "target" date approaches. These funds have become quite popular, and growth in target date fund assets is likely to continue since these funds can be default investments in 401(k) retirement plans under the Pension Protection Act of 2006. However, target date funds have produced some troubling investment results. The average loss in 2008 among 31 funds with a 2010 retirement date was almost 25 percent. In addition, varying strategies among these funds produced widely varying results. Returns of 2010 target date funds ranged from minus 3.6 percent to minus 41 percent.

These returns cause concern for investors and regulators alike. I can assure you that SEC staff is closely reviewing target date funds' disclosure about their asset allocations. In addition, in connection with our joint hearing with the Department of Labor, we will consider whether additional measures are needed to better align target date funds' asset allocations with investor expectations. Among other issues, we will consider whether the use of a particular target date in a fund's name may be misleading or confusing to investors and whether there are additional controls the SEC should impose to govern the use of a target date in a fund's name.

I also have asked the staff to prepare a recommendation on rule 12b-1, which permits mutual funds to use fund assets to compensate broker-dealers and other intermediaries for distribution and servicing expenses. These fees, with their bureaucratic sounding name and sometimes unclear purpose, are not well understood by investors. Yet in 2008, rule 12b-1 was used to collect over \$13 billion in investors' funds out of fund assets. It is essential, therefore, that the SEC engage in a com-

prehensive re-examination of rule 12b-1 and the fees collected pursuant to the rule. If issues relating to these fees undermine investor interests, then we at the SEC have an obligation to step in and adjust our regulations.

In addition to these initiatives, the agency continues to annually review 5,000 corporate filings, over 1,000 SRO rules, and nearly 3,000 new investment company portfolio disclosures. We establish the standards for 13 securities exchanges, 4 securities futures product exchanges, FINRA (a national securities association), the Municipal Securities Rulemaking Board, 10 nationally recognized statistical rating organizations, 10 registered clearing agencies, approximately 600 transfer agents, and securities information processors. Despite the extreme volatility and uncertainty in the markets over the past year, transactions continue to trade at both record volumes and record speed.

SEC RESOURCES

The financial crisis has reminded us just how large, complex, and critical to our economy the securities markets have become in recent years. Whereas the dollar value of the average daily trading volume in stocks, exchange-traded options and security futures was \$10 billion a day in February 1989, over the last 20 years it has grown to over 25 times that size, reaching approximately \$251 billion a day in February 2009. And not only has the size of our markets exploded, the number and size of its participants have jumped as well. For example, since 2005, the number of registered investment advisers has increased by 32 percent, and their assets under management have jumped by over 70 percent to reach more than \$40 trillion as of the beginning of this fiscal year. Broker-dealer operations have expanded significantly in size, complexity, and geographical diversity, as exemplified by the 67 percent rise in the number of broker-dealer branch offices. In all, the SEC's 3,652 staff now oversee more than 35,000 registrants, including about 12,000 public companies, 8,000 mutual funds, 11,300 investment advisers, 5,500 broker dealers, and 600 transfer agents. By comparison, other financial regulators often have close to parity between the number of staff and the number of entities they regulate. For additional detail, attached to this testimony is an appendix, "SEC Staff Levels Have Not Kept Pace with Industry Growth."

Yet at the same time that the securities markets have undergone such tremendous growth, the SEC's resources have fallen further and further behind. Between fiscal year 2005 and fiscal year 2007, the agency experienced 3 years of flat or declining budgets, losing 10 percent of its employees and severely hampering key areas like our enforcement and examination programs. In the context of rapidly expanding markets, I believe these reductions in the SEC's staff seriously limited the agency's ability to effectively oversee the markets and pursue violations of the securities laws.

With support from this subcommittee, during the last 2 fiscal years, the SEC has been able to lift its hiring freeze and begin rebuilding its workforce. By increasing the SEC's appropriation for this fiscal year, approving a reprogramming of additional resources, and just recently supporting emergency supplemental funds for the agency, this subcommittee has expressed its strong support for the SEC and its mission. I am very grateful for that support.

However, even with these important steps, the number of staff with which the SEC can detect fraud, prosecute wrongdoing, ensure proper disclosure, conduct strong oversight of the markets, and take other actions to protect investors, is still significantly below the levels of only a few years ago. Under the SEC's current funding level, the agency's workforce still will fall about 200 staff, or about 5 percent, short of the fiscal year 2005 level.

I believe additional resources are essential if we hope to restore the SEC as a vigorous and effective regulator of our financial markets. The President is requesting a total of \$1.026 billion for the agency in fiscal year 2010, a 7 percent increase over the fiscal year 2009 funding level. This proposal would permit the SEC to fully fund an additional 50 staff positions over 2008 levels, enhance our ability to uncover and prosecute fraud, and begin to build desperately needed technology.

Specifically, these positions would help the SEC's Enforcement program enhance its pursuit of tips, complaints and other leads, thus increasing the resources the SEC can dedicate to frauds that citizens bring to our attention. They would also allow us to hire more trial lawyers and staff with specialized skills that will help our Enforcement program's efficiency, expertise and success. The Examination program would hire market experts to strengthen risk-based oversight of the investment management industry and expand its inspections of credit rating agencies. Our Division of Trading and Markets would strengthen its oversight of entities that play critical roles in our markets, such as broker-dealers, exchanges, clearing cor-

porations, and other self-regulatory organizations. And the President's Budget would allow us to expand our Office of Risk Assessment by fully funding our program to bring in seasoned industry professionals to help uncover hidden risks to investors.

Although expanding our workforce is a critically important step, I believe we also must give our staff better tools to conduct oversight of vast financial markets. That is why the President's request for fiscal year 2010 also contains funds for additional investments in our information systems. Investments in new systems have dropped by more than half over the last 4 years, and as a result the SEC has a growing list of technology needs that have gone unfunded. With the additional IT funds provided under the President's Budget for fiscal year 2010, I would plan to focus on several key projects:

First and foremost, we would use additional funds to enhance our systems for handling tips, complaints and referrals. Although the SEC has a number of different processes to track this kind of information, there is no central repository or system through which this information comes together to ensure it is handled consistently or appropriately. Nor is there any present capability to mine the data to find connections, patterns or trends that would enable us to more intelligently focus our enforcement efforts.

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

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

I came to the SEC to shape public policy in the interest of investors and to strengthen our enforcement program. The things I have described in this testimony are important to those efforts. But what I have also discovered in the past 4 months is that much attention needs to be focused on the internal operations of the agency, the processes that guide our work, the agency's infrastructure and how we are organized. I have been disappointed to find that in some areas of our internal operations, we fall short of what the taxpayer has a right to expect of us, and what our employees have a right to expect of a world class organization. I am committed to a complete review of areas large and small, including FOIA operations, call centers operations, records management, and others, to ensure that we meet the highest standards and that we are fully supporting the important work of our employees in these operations. Doing this will take time and energy and focus. To ensure that we do it well and thoroughly, I intend to bring in a Chief Operating Officer to manage the process. Federal agencies do not manage themselves; we must be actively engaged in that process everyday.

In one area, we have already made progress: we are moving to build an internal compliance program that is second to none. The public appropriately holds the SEC to a very high standard for integrity and professionalism, and we hold ourselves to that very high standard as well. That is why I have initiated several steps to guard against inappropriate securities trading by SEC staff, as well as to avoid any appearance of inappropriate trading. Among other steps, the agency has drafted new internal rules that would prohibit staff from trading in the securities of companies under SEC investigation, regardless of whether an employee has personal knowledge of the investigation, and require preclearance of all trades. The SEC also is contracting with an outside firm to develop a computer compliance system to track, audit and oversee employee trades and financial disclosures in real time. Finally, I consolidated responsibility for this area within our Ethics Office and authorized the hiring of a new chief compliance officer. To further enhance the SEC's financial controls, the agency also will continue its multi-year efforts to build an automated, integrated financial management system.

I want to thank you for your continued strong support for the SEC and its critical mission. I believe the steps I have outlined here—strengthening our enforcement program, enhancing risk-based oversight of the markets and leveraging technology—are essential for restoring investors' confidence in both the SEC and in our Nation's securities markets.

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

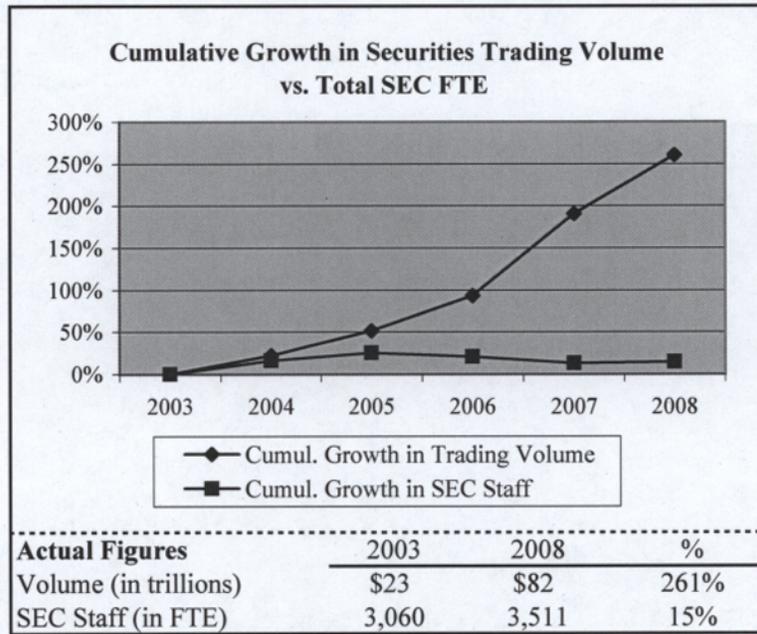
APPENDIX: SEC STAFF LEVELS HAVE NOT KEPT PACE WITH INDUSTRY GROWTH

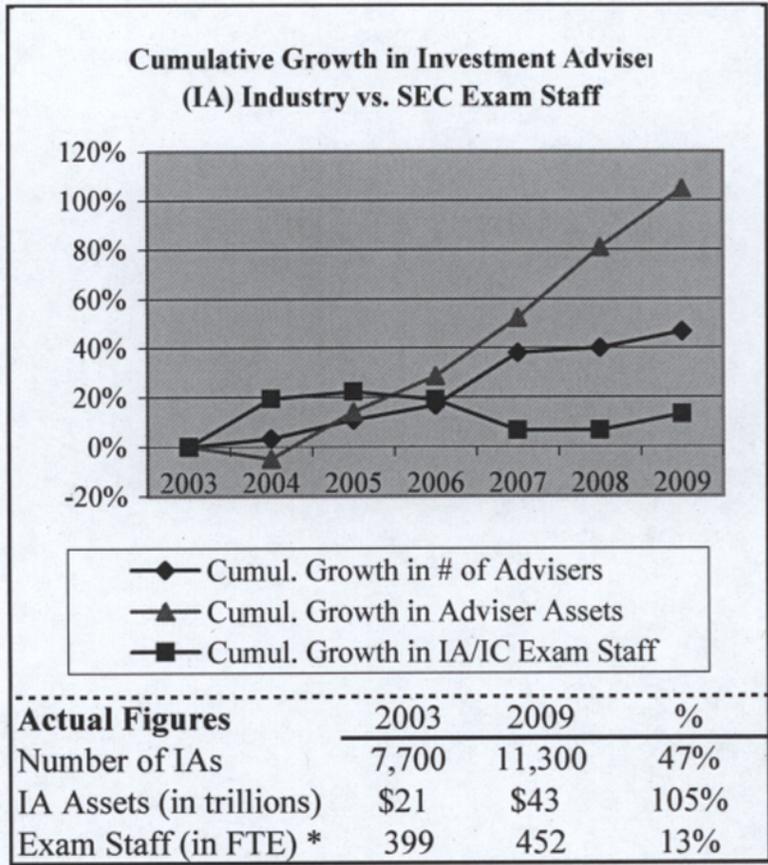
(Tables show cumulative growth relative to 2003 levels)

The SEC's staff of 3,652 FTE (estimate for fiscal year 2009) oversees more than 35,000 entities. These include:

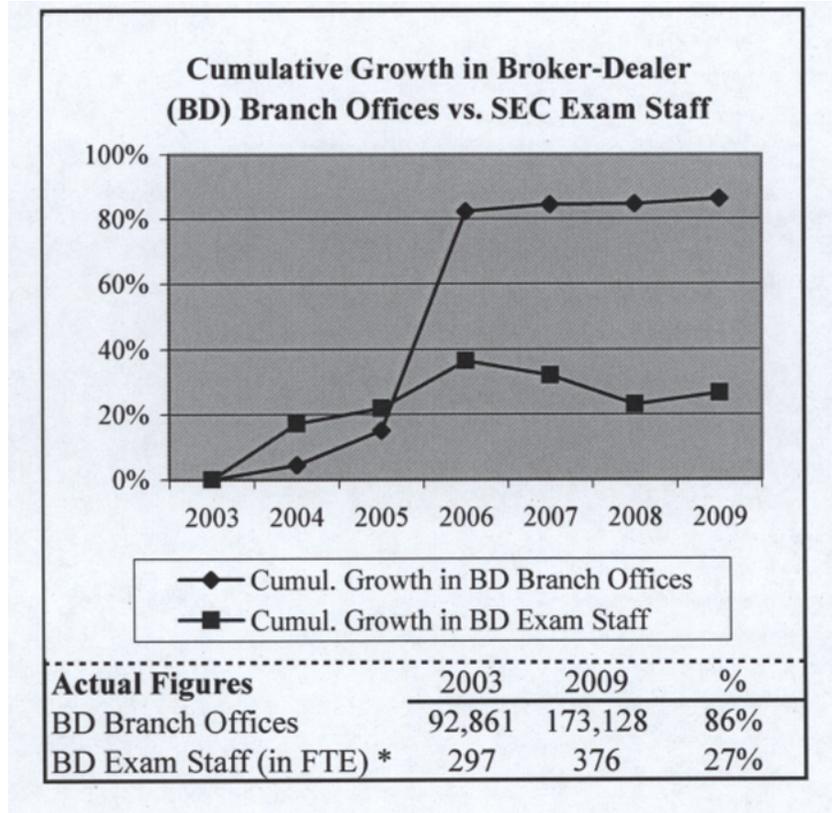
- 11,300 investment advisers;
- 5,500 broker-dealers;
- 8,000 mutual funds;
- About 600 transfer agents;
- Clearance and settlement systems;
- 11 securities exchanges;
- 12,000 public companies;
- 10 credit rating agencies;
- FINRA, MSRB, and PCAOB.

The following charts display how various aspects of the markets have grown since 2003, relative to the SEC's staff:





* The FTE figures for FY 2009 are estimates.



BUDGET AND WORKFORCE OF THE SEC

Senator DURBIN. We'll have 5-minute rounds here, and I'm sure we'll have several questions.

It seems to me that there are two things we're dealing with here just on the surface. First, the number of people working in your agency. It appears that over the years, as Senator Collins noted, we've allowed the number of professionals working there to decline in real terms and certainly decline precipitously in relation to the volume of trade that you have to keep an eye on.

Between 2005 and 2007, the SEC lost 10 percent of its employees, if you can imagine at that moment in time, undermining the agency's ability to oversee the markets, and at the same period of time, the market ballooned in size and complexity.

Registered investment advisors grew 32 percent, assets jumped by over 70 percent, and so we're seeing the caseload or at least the area that needs to be regulated is growing and the number of people to keep an eye on it is diminishing.

So there is, in the first instance, the question of the right number of people working at the agency, and the second issue goes to—I don't know how to characterize it—I guess the internal culture of the agency.

Bernard Madoff was a wake-up call. The fact that this man could swindle as many people as he did with impunity for so long to me is nothing short of amazing.

According to SEC data, in fiscal year 2008, the SEC staff handled over 600,000 tips sent by individuals to your Enforcement Complaint Center. I did a calculation. I think that's more than 2,000 a day for every business day. People sending in items you ought to look at. Well, that to me is an overwhelming number and perhaps you could put it in some kind of perspective.

Now, some have taken a look inside your agency and asked whether the enforcement function within the agency is a healthy one. Is there a risk-averse culture within the SEC to step up and say, you know, we ought to take a look at this Mr. Madoff or people like him?

So let me ask you at the outset, number 1, what would be the optimal number of people that you believe you need to do an effective job at the SEC in light of the volume of business that you have to regulate, and second, do you perceive a cultural problem within the agency when it comes to enforcement?

Ms. SCHAPIRO. Thank you very much, Mr. Chairman.

I think you've really summarized very well with respect to the staffing pressures on the SEC, the current situation.

With over 35,000 regulated entities and 3,700 staff, it's a job that we really can't do in the way I think the public would like to believe we can do in the sense of routine onsite presence in many regulated entities. That's going to really require that we leverage third parties.

So, for example, in the rules I discussed related to the custody of customer assets by investment advisors, a huge problem in the Madoff area, we're going to rely on PCAOB-registered accounting firms to leverage our capability to ensure the customer assets are being protected by the custodians and by the investment advisors, and we will look for every opportunity we can to leverage third party resources.

But at the end of the day, we do need significantly more staff, I believe, over the next several years to keep up with the growth and the complexity of this industry, and if there are additional responsibilities as a result of regulatory reform that accrue to the SEC in the context of hedge funds, credit default swaps or other areas, that, of course, will require sufficient additional resources because we can't stretch any thinner than we already are.

So I do believe—and if you look at our 2011 budget request, you will see we've asked for a significant ramp-up in the number of full-time equivalents (FTE), close to 400 FTE and 1,000 new positions, and I believe that if we're able to achieve that number in 2011 or over the course of the next several years, that will go a long way toward getting this agency to the appropriate size to handle the job that's in front of it.

I don't think there's any danger that we're about to become too big in any event.

I think, with respect to your second question, the Madoff fraud is a tremendous tragedy. It's really a tragedy of epic proportions and I think it really will put the onus on this agency to prove that it is capable of managing the responsibilities that it has been given

under the law and it's really critically important for us to ensure that both our culture, our operations, and our procedures, our staff and our skill sets are up to the task.

You pointed out, for example, that we get somewhere around 600,000 to, in peak years, 1½ million tips a year. We can't manage those that come into the organization through a wide variety of entry points. We don't have databases that are connected so that we can do a trend analysis of those tips and complaints or connect that data to external sources of data to see what might be developing more broadly in the marketplace.

Right after I started, I brought in the Mitre Corporation's Center for Enterprise Modernization to do a complete review of how we handle tips and complaints. They've concluded the first round of their work and we're now in the implementation phase of some short-term and intermediate-term remedies and processes to help us manage tips and complaints.

But it's also about leadership and it's about freeing our Enforcement Division to do the kind of job that I know they're capable of doing.

I was at the SEC 15 years ago when the agency had a really first-class reputation for aggressive enforcement and I know we're capable of that again. We have a new Enforcement Director who's very committed to bringing large cases in a timely way that have the maximum investor protection impact.

It's about enabling our enforcement staff through technology and the right skill sets to bring those kinds of cases, that when a whistleblower presents them with information, as had happened in the *Madoff* case, they have the ability to understand it and pursue it. It's about being a little bit humble about the information that comes to us and appreciating that there may be real value in what's being presented to us.

We're also going to seek whistleblower legislation to enable us to reward whistleblowers, as the Internal Revenue Service (IRS) and other agencies do, when they bring us well-formed cases and documentation, a fraud that we can then pursue, and it's about filling the regulatory gaps, through such as the custody requirements I just spoke of, so that we are sure that the regulatory regime, coupled with aggressive enforcement, coupled with the tools and the skill sets, combine to create an agency that's absolutely committed and focused on investor protection.

I'm sorry. That's a very long answer.

Senator DURBIN. No. It's a very good answer, and I thank you for it, and I'm going to turn to Senator Collins and return in later rounds.

Senator COLLINS. Thank you, Mr. Chairman.

Ms. Schapiro, you talked about the increased number of positions that you have requested as part of the fiscal year 2011 budget, but in fact, the President's budget for this coming fiscal year does not allow you to hire any new positions, is that correct?

Ms. SCHAPIRO. That's correct, Senator. The increase in the 2010 budget covers the annualized costs of the increases in the fiscal year 2009 budget that we were able to have as a result of the approval of our reprogramming requests and taking \$17 million of

unobligated funds from prior years, dedicating those to staffing, additional staffing in 2009.

The annualized costs of those additional 50 positions that we're bringing on this year are the increase in the 2010 budget.

Senator COLLINS. Do you need new positions for the upcoming fiscal year?

Ms. SCHAPIRO. Well, I would say that we're, first of all, extremely grateful to the President for the increase in the 2010 budget and it's a meaningful increase for this agency, and as I pointed out, 2011 we sought a much greater increase.

The opportunity to start to move toward that 2011 budget earlier would be a wonderful opportunity for us to bring that number of staff on over a 2-year period rather than all in 2011, if Congress ultimately approves that number.

Senator COLLINS. Because I am troubled that the current funding level supports a staff that is 5 percent lower than your peak level back in fiscal year 2005.

If you look at the growth of regulated entities and if you look at the amount of money involved, if you look at the number of American families who now have savings in the stock market, the fact that these staffing levels are below what they were 5 years ago is troubling to me.

So are you saying that it would be helpful to be able to ramp up those staffing starting in the next fiscal year rather than waiting to fiscal year 2011?

Ms. SCHAPIRO. Absolutely, it would be helpful. The reprogramming request, in addition to allowing us to get a little bit of a jump on 2010, enabled us to do some technology investment.

We need fundamentally more investment in technology at the SEC to support our Enforcement and Examination Programs and we can use more boots on the ground in Enforcement and Examination, absolutely.

INVESTOR PROTECTION AND EDUCATION

Senator COLLINS. Aggressive enforcement is absolutely critical, but there's another way that's important for protecting investors, particularly smaller investors who may be less sophisticated in choosing their investments, and that is through a robust education effort.

You've spoken a lot about the need to protect investors and I know that in my State, I've seen thousands of individuals who have seen their retirement nest eggs shrink, money set aside for their children's college education virtually disappear, and they're wondering what can be done about it. They're seeking more information.

Several years ago, the SEC used to conduct very valuable educational sessions, town meetings, outreach to seniors groups.

What are your plans to reach out to investors, particularly small investors or senior citizens, in two ways; one, to help them better understand risk and suitability requirements, but, two, to help them spot scams?

Ms. SCHAPIRO. It's a wonderful question, and I'm very committed and personally quite passionate about investor education and had a program at my former employer, FINRA, as Senator Tester

knows, where we did investor forums which the SEC used to do years ago around the country and to great success and with tremendous participation all over the country.

The SEC has a small program that does that now. Commissioner Walter in fact did an investor forum just last week with our Boston office in the State of Maine.

My plans would be, given sufficient resources, that we dramatically increase that program, that we enable our offices around the country to provide local education in senior citizens centers, community centers, local high schools, and that we really take a leadership role in the Federal Government in educating investors about the kinds of questions they need to ask when they're being offered investment products, about the kinds of scams and pitfalls that they need to be on the alert to.

I'm very concerned, given the current environment and the amount of money people have lost in their retirement plans and in their other investments, that they will be reaching to try to make that money back through some particularly risky investments. I have no doubt that the scam artists have already figured this out and are beginning to prey on people's real fears about their financial futures.

I think the SEC can play a critical role here, bringing together other agencies of the Federal Government but also on its own, reaching out very directly as well as through the development of content put on websites and in investor forums.

Senator COLLINS. Thank you. Glad to hear it.

Senator DURBIN. Senator Tester.

Senator TESTER. Thank you, Mr. Chairman.

Chairman Schapiro, you come into an agency, the SEC, that has been around about 75 years and to be honest, from my perspective, probably come into it at a time when it's hit an all-time low as far as both morale and effectiveness. So you've got to rebuild this agency, I think, maybe not from the ground up but from the foundation up.

We've talked about manpower levels. If you have the technology that you spoke about, do you have a figure in mind about what the right number of people are for this agency, considering the massive workload?

Ms. SCHAPIRO. I think it's very hard to give an exact number. As I said, our 2011 budget request seeks 1,000 additional positions which would take us to just under 5,000. That would still be smaller, for example, than the Federal Deposit Insurance Corporation (FDIC) which regulates about 5,000 to 6,000 banks.

Senator TESTER. Okay.

Ms. SCHAPIRO. I do think there's also practical limitation on how many people you can just bring on board and train—

Senator TESTER. Right.

Ms. SCHAPIRO [continuing]. At any given time. The faster that we can move toward a substantial increase like that I think the better.

Senator TESTER. Okay.

Ms. SCHAPIRO. It also depends largely on our ability of effectively utilized technology to save on human resources.

Senator TESTER. Right on. Consumer confidence is one of the things that everybody's concerned about. Nobody—you know, we've lost a bunch of money. People's confidence is shaken.

RESTORING INVESTOR CONFIDENCE

What do you see as being two or three of the major things that you have to do in your agency to have consumer confidence back at a level that's reasonable, and, quite honestly, what do you see we need to do, the two or three things that we need to do to help re-establish consumer confidence with the groups that you regulate?

Ms. SCHAPIRO. I think it's a great question. I think enforcement is just a part of what we do, but it's a very visible part, and I think it's really critical for investors to see that there is a cop on the beat who's trying to ensure that the playing field is level, that the insiders aren't taking advantage of the rest of the participants in the marketplace.

So we need to have a very timely enforcement response to the problems that arise in the marketplace and short of doing that, I think people won't have confidence. We can write all the rules we want, but if nobody's enforcing them, we're not going to restore investor confidence.

I think investors also need to have complete confidence in the transparency of corporate disclosure. They need to believe that the companies in whose stock they are buying are getting them the accurate numbers and the accurate disclosure and information about that company's prospects so they can make informed decisions about where to put their money.

And I think we have to have a focus on consumers issues, on mutual funds sales, on sales practices generally, on the issues around fees and fee structures and disclosures that investors really care about at the end of the day.

We'll be announcing later this week the creation of an Investor Advisory Committee for the first time in many, many years at the SEC that will give investors a regular way to interact with the Commission on policy issues that are of interest to them.

I think we have to reorient everything we do toward rebuilding the investor confidence in both the agency and in the fairness of our markets.

Senator TESTER. What do we need to do, Congress?

Ms. SCHAPIRO. I think supporting the agency, quite honestly, as the appropriators with sufficient resources to accomplish what we need to do and hold our feet to the fire that we're delivering on the commitments that we're making to the American public.

Senator TESTER. Have you been able—I mean, there's been talk about the future roles of the SEC, the CFTC that we'll hear from shortly, after a regulatory modernization has been done.

Assuming that that goes forward, can you talk about the challenges, opportunities, possible consequences of merging your two agencies?

Ms. SCHAPIRO. Sure. And, you know, I have the unique position of having been Chairman of the CFTC and now Chairman of the SEC. So in honesty, I can tell you I've argued both for and against merger over the years.

I think it's obviously a decision that's ultimately for the Congress about whether or not to combine the two agencies. Short of that, I believe that with Gary as Chairman of the CFTC that we can have an incredibly positive and constructive working relationship, to ensure that products and practices don't fall between the cracks of the two agencies and that we don't leave large swaths of the financial markets unregulated and unaccountable to the American public—

Senator TESTER. Do you think that would be—excuse me. Do you think that would be done better if you were combined?

Ms. SCHAPIRO. I think—in my personal view, there is a logic and an efficiency that can be achieved from the merger of the two agencies, but short of that, I also think that the two agencies can do a better job of working together to ensure the protection of investors.

Senator TESTER. My time is up, but we'll be back.

Senator DURBIN. I was just advised by my colleague that there's a vote on and I'm going to try to continue asking until someone returns, but I ask the indulgence of our witness and those in the audience as we try to balance a few things here.

ADDRESSING RESOURCE CONSTRAINTS

The numbers of investigative attorneys at the SEC decreased 11.5 percent between fiscal years 2004–2008 and some believe that that's resulted in delayed cases, reducing the number that can be brought to trial and potentially undermining the quality of cases that are pursued.

How have resource constraints impacted the effectiveness of the SEC?

Ms. SCHAPIRO. There's no question but that—and there's a recent Government Accountability Office (GAO) report that suggests this, as well, that the resource constraints have hindered the ability of the Enforcement Division to pursue as many cases in as timely a way as I would like to see.

In addition, there are some procedural difficulties placed in the path of the Enforcement Division over the last several years that slowed cases down and discouraged, if not explicitly, implicitly seeking penalties from corporate issuers in certain kinds of cases, and we've eliminated those hurdles and cases can be started much more quickly now. Investigations can be pursued with the approval of one commissioner, not the full Commission sitting in a meeting.

We've eliminated what was called the Penalty Pilot Program completely and we are reorganizing the Enforcement Division under the leadership of our new Director in a way that we hope will eliminate some layers of management and some of the stovepiping that's existed over the years and allow us to be more nimble and more aggressive, pursuing much larger cases, particularly those arising out of the financial crisis.

Senator DURBIN. On another issue, there was a mindset for a long period of time that as long as the economy was expanding and wealth was being created, we didn't dwell and ask a lot of embarrassing questions, but with the downturn in the economy, downturn in the fortunes of many families and the investment of our Federal Government into many of the largest businesses in Amer-

ica, there appears to be an awakening on the part of the average person about how many corporations are being managed and particularly in the area of executive compensation.

CORPORATE GOVERNANCE

I won't go into chapter and verse about bonuses given to executives who have nothing to show for it, other than failure, but let me ask you, what is the SEC currently doing to improve the accountability of corporate directors and enhanced disclosure of executive compensation?

Ms. SCHAPIRO. Mr. Chairman, I've made corporate governance one of my highest priorities in the last 4 months. We are engaged in a couple of things.

First of all, in May we approved for comment a proposal that will facilitate the ability of shareholders to nominate on the company's proxy directors to serve on the corporate—on the company's board and it's out for comment now. It will be highly controversial, but if ultimately approved and not challenged in court, it will greatly facilitate the abilities of shareholders to elect nominees to corporate boards and thereby hold directors more accountable for their oversight of the corporation.

With respect to compensation in particular, as you know, we already require disclosure of all plan and non-plan compensation by the senior-most officers of a company.

Next month we will be considering amendments to the compensation disclosure rules that will simplify something called the summary compensation disclosure table to provide more information there about compensation.

It will require disclosure about the overall compensation approach within the company. There will be enhanced disclosure about the use of compensation consultants who are sometimes in a conflicted position in advising both the compensation committee and the company's management, and we're going to require disclosure about the linkage between compensation plans and risk-taking by executives, traders and others within the company, so that investors will be able to understand how risk-taking which was such an important component of the financial crisis has been potentially incentivized in some companies.

CREDIT RATING AGENCIES

Senator DURBIN. On another issue, in late 2006 the Credit Rating Agency Reform Act gave the SEC exclusive authority over rating agency registration and qualification. In the less than 3 years since enactment the SEC has undertaken no fewer than five rulemakings to implement the law. These rules, which are all still relatively new, extend from registration and recordkeeping to disclosure and managing conflicts of interest.

Yet, even though the credit rating agencies were under SEC's purview, rating agency performance in the area of mortgage-backed securities backed by residential subprime loans and the collateralized debt obligations linked to such securities has shaken investor confidence to the core.

It used to be that credit ratings were kind of like the gold standard in terms of whether you could trust a business to be in solid financial shape. Well, I think a lot of questions have been raised.

What are you doing at the SEC now to restore consumer and investor confidence, and what improvements are needed in the way that you monitor credit rating agencies?

Ms. SCHAPIRO. There's no question but that credit rating agencies played a significant role in facilitating, I guess, in some ways the financial crisis.

The agency has engaged, as you point out, in many rulemakings, most recently the rule in 2008 which required a series of disclosures about performance statistics, the different kinds of models that were used for initial ratings versus surveillance ratings, documentation, disclosure of conflicts and so forth.

The Credit Rating Agency Reform Act, which Congress passed in 2006, specifically does not allow the agency to regulate the substance or the procedures or the methodologies of the rating agencies and something we're looking at is whether we need to ask Congress to reopen that legislation to provide greater authority.

Senator DURBIN. Who does?

Ms. SCHAPIRO. Nobody. But nonetheless, despite the limitations in the law, we are looking at doing a couple of things.

One is my perhaps my greatest concern in this area is something called ratings shopping which allows the creator of a structured product to get preliminary ratings from multiple rating agencies and then select the one they want to rate the product, presumably that being the highest rating they've gotten.

Senator DURBIN. Wish I could have had that for my report card in grade school.

Ms. SCHAPIRO. Don't we all?

Senator DURBIN. Shopping teachers.

Ms. SCHAPIRO. Exactly. If you'll give me an A, I'll take your class is what it amounts to.

So we're looking at what we can do with respect to rating shopping. Removing references potentially to ratings in the Federal securities laws and regulations which gives an air of credibility and respectability to ratings that perhaps they don't entirely deserve, looking at whether we should require different symbols for rating structured products versus rating plain vanilla corporate debt, and we're looking at more detailed disclosure about how ratings have performed over time.

So there's some things the SEC clearly can do and we are doing. We held a roundtable with rating agencies just about 1 month ago to explore some of the failures of the different business models and some of the—not the failures of the different business models but the different business models, some of the other failures that have become clear over the last year.

We're moving ahead with what we can do and we will come back to Congress if we believe at the end of the day we need more authority.

Senator DURBIN. Thank you. I'm going to ask that the subcommittee stand in recess for just a few moments and as soon as Senator Collins returns, I'm going to ask her to resume the hearing. I apologize, but it just so happens we have a rollcall vote.

The subcommittee will stand in recess.

Senator COLLINS [presiding]. The hearing will reconvene.

In Senator Durbin's absence, he's permitting me to continue the hearing. I'm certain he'll be back very soon. He's just voting.

Ms. Schapiro, last September the SEC's inspector general issued a report on its investigation of the Consolidated Supervised Entity Program, the CSE Program, through which the SEC monitored the five major investment banks.

This inspector general report found that the SEC has severely understaffed its CSE Program and thus could not effectively manage its responsibilities to monitor or question these investment banks.

As you know, I'm particularly concerned that an investment bank like BearStearns was allowed to have a leverage ratio of 30:1, truly astonishing, and yet it appears that there was not a system in place, other than a very loose voluntary system that the SEC had, to monitor these banks, and in many ways this report was truly prescient since just a few months after it was issued none of these investment banks existed anymore. They all had either failed, been acquired or merged into bank holding companies.

REGULATION OF LARGE INVESTMENT BANKS

Let me ask you a number of questions about this. First, does the SEC have the right mix of staffs to conduct the kind of oversight of a large investment bank? A lot of the SEC's employees are attorneys which is obviously very useful and helpful on the enforcement side, but does it need more auditors, more economists to have the expertise to analyze complex financial data and risk models? So the first question is the mix of expertise.

Ms. SCHAPIRO. I believe that we haven't historically had enough financial analysis experience, experience with structured products and complex derivative products.

In the last couple of months that's been an area of focus for recruitment, not just in the Enforcement Program but also in the Trading and Markets Division which has responsibility for broker-dealer risk oversight. So that even though the CSE Program is discontinued, there are still a large number of—not maybe a large number but a number of large investment banks and broker-dealers for whom the SEC still has responsibility.

That's an area that we are building and increasing our capability in in a very conscientious and sort of directed way and have been working on over the last couple of months. It's really important for us to have that capability.

Even with the presence ultimately of a systemic risk regulator, that's the result of regulatory reform, it will be important for the SEC, as the day to day regulator of over 5,000 broker-dealers, to have the capability to really understand the financial and operational status and condition of those brokerage firms.

Senator COLLINS. Second, how should—I realize these large investment banks don't exist any more but they could reappear. How should they be regulated for safety and soundness?

I cannot imagine a federally or State-chartered bank being allowed to have a leverage ratio of 30:1.

Ms. SCHAPIRO. I think the answer is they need to be regulated on a consolidated basis. So that, as you know, the securities laws are generally geared toward the protection of customer assets within the broker-dealer, but there are affiliates of the broker-dealer, there's a holding company structure, there are a lot of other entities where significant risk can be taking place, and it's important that the regulator of the entire entity have a view into what's going on in all of the related parts of the operation, so not just in the broker-dealer but also in the holding company affiliates and subsidiaries.

It is that consolidated view that will allow our regulator to make a judgment about whether leverage is excessive, capital is sufficient, the quality of management across the enterprise is up to the task.

Senator COLLINS. Another reform that we need is the ability to identify and prevent what I refer to as regulatory black holes, and the emergence of credit default swaps or other exotic and poorly disclosed derivatives certainly indicates that the current system has not been sufficient to prevent gaps in regulation of products or practices that can have consequences for the entire financial system. That's why I support having a council of regulators to look at systemic risk.

ROLE OF A SYSTEMIC RISK REGULATOR

What do you think are the advantages and disadvantages of a council approach versus vesting in the Federal Reserve the authority to be the systemic risk regulator?

Ms. SCHAPIRO. Well, I'm very much in agreement that the existing regulatory regime is riddled with holes and that there are large parts of the financial marketplace that were really not under the regulatory umbrella at all or in any meaningful way and credit default swaps is an example. Hedge funds and some other private pools of pooled funds would fall into that category, as well.

As you know, I like the concept of a council, whether it's a stand-alone council or in conjunction with a systemic risk regulator, because it brings a diversity of perspective that I think is really important to identifying where gaps may be arising, where new products may be being created in the intricacies between regulatory authorities, so that we can avoid those potentially harming the system.

And when you have a council of regulators, where you've got securities regulators, for example, which is very much focused on investor protection and transparency and bank regulators very much focused on prudential standards and safety and soundness, and insurance regulators with yet another perspective, I think you have a better chance of capturing the entire financial landscape and the potential places where those new products are arising, where those new gaps are being created.

At the same time I think there needs to be the ability, whether it's a council or a single system risk regulator or a combination, to step in and raise standards when necessary, where the functional regulator may not be aggressive enough in requiring higher capital standards or reining in leverage, that there be the ability ultimately to protect the system, to force those kind of changes.

Senator COLLINS. Thank you. Senator Tester. It's nice being temporarily chairman.

Senator TESTER. Thank you. Thank you, Senator Collins, and you're doing a fine job, I might add.

ENFORCEMENT OF THE SECURITIES LAWS

Secretary Schapiro, I'm sure you read the article yesterday in the Washington Post that dealt with enforcement actions of the SEC over the past few years. If that article's true, it is more than just a little bit distressing.

You have stated the imperative to take the handcuffs off the Enforcement Division. That article yesterday would imply to me that I don't care how much money we put at the agency, if people on top are making arbitrary decisions about how to not do their job appropriately, no amount of money is going to make it work correctly.

You're not going to do that, I know that. I've met you and long before when you were in FINRA, as you stated in your opening statement, in Montana and did a fine job education-wise and you have done a fine job in this position.

But could you just give me a little bit of insight on how this budget would help you accomplish the goal of taking the handcuffs off the Enforcement Division?

Ms. SCHAPIRO. I'd be happy to. I should say that in my 4 months at the agency, I talk a lot about enforcement. I've done some town halls with the staff. I e-mail with the staff.

I will tell you that the response has been tremendous eagerness and enthusiasm on the part of employees to get back to what we do and what we can do so well and—

Senator TESTER. Good.

Ms. SCHAPIRO [continuing]. Particularly in the enforcement context.

I think what the budget will enable us to do is have more people to bring the cases that need to be brought. We are not in danger of running out of cases. So on a very simplistic level, more people will enable us to do that.

Bringing in the right skill sets so that we're not risk averse, so that we're not afraid to tackle the most complex trading strategies or the most complex products or the most complex frauds will be important. So we need to train our people better in more sophisticated methodologies. We need to bring in the right kinds of skill sets, as well, and we need to support our people with technology.

The amount of data that comes into the agency that is unmanageable, even in the course of one major litigation, is extraordinary and we have our people wasting their times archiving e-mails and dealing with millions and millions of records when we should be able to rely almost solely on technology to do that.

We need technology to help us sort out the tips and complaints that we get, as I spoke about earlier.

Senator TESTER. The ranking member talked about potentially inadequacies of this budget. In a previous line of questions, you said you can't bring on everybody you need because it's simply impossible to manage that influx of people.

Is the budget adequate to get to where you need to go? I'm sure you have goals, either written or mental, where you want this agency to go. Is this budget adequate to get you where you need to be a year from now?

Ms. SCHAPIRO. As I said, we are genuinely grateful to the President for the increase the 2010 budget represents over 2008 and 2009. We've asked for a very significant increase in 2011 and the ability to get to that number sooner, we could handle, and I think it would make a difference in our ability to do our job.

REGULATION OF SHORT SELLING

Senator TESTER. Okay. Uptick rule. Can you discuss the Commission's effort to reinstate the Uptick rule, what's the likelihood, timing and opposition to that?

Ms. SCHAPIRO. I would be happy to do that. This is an issue of enormous, enormous public interest, and it's an issue of investor confidence, as well.

As you know, the SEC took the Uptick rule off a couple years ago after careful study and evaluation. In some ways it was a model rulemaking to eliminate it.

Nonetheless, that coincided with dramatic increases in volatility in the marketplace and investors have been clamoring for us to revisit this issue. In April, the Commission voted unanimously to seek public comment on two different approaches to short selling.

One is essentially the reinstatement of the Uptick rule as we used to know it, with some variations. The other is a short sale circuit-breaker that would be kicked into effect if the price of a stock declined by, say, 10 percent in a day, no short selling thereafter for a period of time.

We've already gotten 3,000 comment letters. The comment period closes in about 2 weeks, and then we will wade through those comment letters and hopefully bring back to the Commission a proposal for consideration.

At the same time we're looking at a couple of other issues. There's a rule, it's a temporary rule that expires in July that's had a very, very positive effect on eliminating or diminishing the fails to deliver in securities and short sales, requiring them to be closed out the next day. I expect the Commission will make that a permanent rule this summer, and we're looking at some other issues, like the potential for pre-borrow requirement.

So we are actively focused on short selling and will continue to do so.

Senator TESTER. Do you anticipate that the proposal you're going to take back to the Commission will be voted on when?

Ms. SCHAPIRO. I think we're looking at August for a vote. The comment period closes toward the end of June. With 3,000 comment letters at this point, I expect significantly more and we'll have to evaluate those, so some time this summer.

Senator TESTER. After the Commission votes on the rule, is it typically an immediate effective date?

Ms. SCHAPIRO. Generally not, if it requires technology changes at either exchanges or brokerage firms.

Senator TESTER. Would this?

Ms. SCHAPIRO. Yes, the reinstatement of the Uptick rule requires significantly more technology work than the circuit-breaker would.

Senator TESTER. Okay.

Ms. SCHAPIRO. So it could be quite dependent upon which of the two approaches.

Senator TESTER. One last and it has to do with this. Who's opposing the Uptick rule from going back into effect?

Ms. SCHAPIRO. I haven't been through the comment letters, to be honest, but I would say historically there's certain kinds of algorithmic traders, some kinds of hedge funds that are large short sellers that oppose it. There are—

Senator TESTER. That are for the most part unregulated at this point in time, right?

Ms. SCHAPIRO. That might be right.

Senator TESTER. Okay.

Ms. SCHAPIRO. There are others who believe that short selling plays a very legitimate role in the marketplace in terms of adding liquidity. It has impacts on options market-makers and others. So there is opposition to reinstatement.

I think the pure weight of the comment letters will tell us that there is much more support for doing something, whether it's the Uptick rule or the circuit-breaker.

Senator TESTER. Thank you.

FEE COLLECTIONS BY AND FUNDING OF THE SEC

Senator DURBIN [presiding]. Thank you. Chairman Schapiro, just for some perspective here, the SEC is fairly unique in that it collects a lot of money in fees and if I'm not mistaken, that number is somewhere a little north of or around \$1.4 billion, is that correct?

Ms. SCHAPIRO. The 2009 expectation is, yes, about \$1.35 billion.

Senator DURBIN. Okay. And the appropriation for your agency is around \$1 billion, a little over \$1 billion.

Ms. SCHAPIRO. Yes, 2009 \$916 billion, including the reprogramming request.

Senator DURBIN. So you are a cash generator—

Ms. SCHAPIRO. We are.

Senator DURBIN [continuing]. In terms of the revenues into the Treasury.

Ms. SCHAPIRO. And historically a very significant cash generator.

Senator DURBIN. And if the argument can be made that the industry is paying your agency to do its job and we've started this testimony here today arguing that you needed more people to do your job, it might be fair for those who are being regulated saying we're doing our part, in fact we're sending you about 40 percent more than you're actually spending in this agency.

Would that be a fair comment?

Ms. SCHAPIRO. It might be.

Senator DURBIN. Okay. Well, this concerns me because if we were going in the other direction, we'd be arguing, well, we need to come up with some revenue source here to provide the regulatory structure to make sure that the Government's doing its job, but in fact the marketplace that you regulate is creating the revenue opportunity.

Ms. SCHAPIRO. That's correct, and actually that doesn't include penalties and fines that are paid into the Treasury in those instances where we don't create a fair fund to distribute back to investors. So there's actually additional funding over the fee generation.

Senator DURBIN. Okay. Let me go to a few more specific questions.

Broker-dealers who sell stocks and bonds on commissions and investment advisors who offer advice are regulated under different Federal laws. The key difference is the rules governing their standard of conduct. Investment advisors held to a fiduciary standard which requires them to make investment decisions in the best interests of their clients. Brokers, in contrast, are held to something called a suitability standard under which they can sell securities as long as they are suitable to their clients.

Interesting little distinction there, but the variations between brokers and advisors has been blurring in recent years and it's raised concern among some regulators that customers won't be able to tell the difference.

I understand that you're taking a look at this.

Ms. SCHAPIRO. Absolutely. There's really no good reason for people not to get the same fiduciary protection and the same standard quality of regulation from people who are essentially giving them the same service but are called by different names.

Senator DURBIN. Let me ask you a question. First, let me preface it by saying I asked my staff this. I said, now is this for Chairman Schapiro or Chairman Gensler. They said, well, you better ask her. So here's a hedge fund issue for you.

The Pension Protection Act of 2006. Would this be your jurisdiction?

Ms. SCHAPIRO. The Pension Protection Act is largely administered by the Department of Labor, but there are elements that intersect with the SEC.

Senator DURBIN. Okay. Let me give you the situation. You tell me if this is something that you think falls in your jurisdiction.

This Pension Protection Act made it easier for hedge funds to take pension money without registering it as an ERISA fiduciary, meaning they don't have disclosure and other requirements of other pension plan managers. Is this your field?

Ms. SCHAPIRO. This is the Department of Labor, I believe.

Senator DURBIN. Okay. Let me stop at that point and save this for the Department of Labor then.

REGULATION OF DERIVATIVES

Derivatives, contracts between two investors, betting on whether a stock, bond or other security will go up and down in value have ballooned into one of the world's largest trading markets, estimated to be tens of trillions of dollars, yet it's largely outside the regulatory umbrella. Losses, as we know, at AIG have led to a Government bailout of \$170 billion or \$180 billion.

On May 13, President Obama unveiled a plan to regulate this market which had four stated goals.

What do you consider to be the role of the SEC in this regulation?

Ms. SCHAPIRO. This is such an important area for both the SEC and the CFTC and, as you point out, the Treasury letter of May 13 lays out some requirements that we hope will be embodied in legislation with respect to credit default swaps and other standardized over-the-counter derivatives.

It will be very important to have standardized clearing mechanisms, potentially exchange trading of standardized contracts, promote transparency, have adequate margin and collateral requirements in place for these transactions and subject the dealers in these instruments to regulation.

Exactly where the lines between the SEC and the CFTC fall, I think, are something we'll be discussing certainly over the next several weeks, but it is clearly my view, and I believe Chairman Gensler's view and the Treasury's view, that we need to work together to ensure that we bring credit default swaps and other OTC derivatives firmly under the Federal regulatory umbrella and how we exactly draw those lines will be something we'll be discussing and obviously Congress will have a deep interest in, as well.

Senator DURBIN. I'll ask a question that relates to last week it was reported that two attorneys from SEC's Enforcement Division engaged in suspicious trading in stocks of companies under SEC investigation, according to a March 3 report by the SEC Inspector General David Kotz.

Mr. Kotz concluded that the SEC previously had essentially no compliance system in place to ensure that its employees did not engage in insider trading themselves. On May 22, the SEC issued a press release outlining how the agency would increase accountability.

How will this new process impact the current SEC workload? Will it require additional resources or staff to implement?

Ms. SCHAPIRO. Thank you for asking that question. It's really an important area.

When I learned about this inspector general report in March, I immediately set in motion—and some things were already underway, I should say—a number of changes to our process which was acceptable under the Office of Government Ethics rules but clearly not sufficient in my view.

We now require all trades by employees to be pre-cleared. We've created a restricted list that prohibits an employee from trading in any stock of a company that's under investigation by the SEC, whether they know anything about the investigation or its existence or not.

We prohibit any ownership in stocks of broker-dealers, investment advisors, publicly traded exchanges, and we're requiring employees to authorize that their brokers in duplicate trade confirmation statements to the SEC where they will be incorporated into a computerized system that will make monitoring compliance with all of these new rules much more effective, and we'll be hiring a chief compliance officer. I expect we'll sign the contract for the new system in the next several days and it should be operational in 1 to 3 months.

The new rules requiring pre-clearance of all trades by the Ethics Office and the creation of the prohibited list and so forth are pend-

ing at the Office of Government Ethics and have been there for about a week. We jumped on this immediately.

Senator DURBIN. Thank you very much.

Senator COLLINS.

Senator COLLINS. Thank you, Mr. Chairman.

CONSUMER PROTECTION

Ms. Schapiro, there is an idea that is being discussed to consolidate the consumer protection functions of a variety of regulators under a single entity and one such proposal would result in the SEC losing its consumer protection responsibilities.

I personally don't think this makes any sense at all because to me, the whole reason we have an SEC is to act to protect consumer investors.

What are your views on creating a single consumer protection entity that would include the SEC's responsibilities?

Ms. SCHAPIRO. I think that it certainly is one of the ideas that's being bandied about and there are many, and I think discussions continue to be very vigorous and ongoing throughout the regulatory community about the right approach here.

I think the one thing everybody agrees on is that we must have a reorientation toward consumer and investor protection among all of our financial regulatory agencies. So whether we have the creation ultimately of a single entity or we just reheighten and refocus within the bank regulatory agencies and the SEC on the protection of the end users of financial products, we, I think, all agree that we have to go down that path.

My view is that, and it's been reported that, I don't want to create new gaps in the regulatory system and I fear that moving mutual fund regulation out of the SEC and into a new agency has the potential to do that.

Mutual fund—investor protection and the mutual fund concepts, it's about more than the end product of the sale to the investor. It's really about what's the governance of the mutual fund. What's the quality of execution that the mutual fund is getting when it's buying stocks for its portfolio? What's the quality of the disclosure of those companies that the mutual fund is buying? What's the quality of the disclosure that the mutual fund itself is making?

These are all a piece. They're all woven together to create the fabric of investor protection in the mutual fund space and so I want to be sure we don't damage that fabric.

That said, whatever Congress in its wisdom and the administration working together to create that will protect investors better and consumers better, we intend to, you know, play as strong a role as we can.

Senator COLLINS. Thank you. Mr. Chairman, I'm just going to ask one final question, if I may, and that has to do with the credit rating agencies. I understand you, too, brought this issue up, but, unfortunately, I wasn't here. I was voting when you did. So I apologize if this is redundant.

I'm very concerned about the role that was played by credit rating agencies in this crisis as far as their ratings of subprime mortgages of mortgage-backed securities.

It seems to me that the current system has so many inherent conflicts of interest built into it, not the least of which is that the credit rating agencies are being paid by the firms that are marketing the securities.

What are you looking at to improve the integrity of the credit ratings process?

Ms. SCHAPIRO. You very correctly highlight that in the issuer paid model where I create a security and then I ask you to rate it and I pay you for that rating and I pay you on an ongoing basis for future ratings, if I'm happy, has profound conflicts of interest and we are looking in particular, as we discussed earlier, at the rating shopping phenomenon which allows me to select the ratings agency that provides or promises to give the highest rating and we're also looking at more robust disclosure about fees that are paid and the conflicts of interest that exist in the issuer paid model.

We held a roundtable about 1 month ago. We brought in all different kinds of rating agencies to talk about their different business models and the pros and cons of each and we've gotten a lot of very good ideas from that process and we're hoping this summer to pursue some additional rulemaking in this area.

We will focus on rating shopping. We will focus on disclosure. We will also look at whether we need to eliminate references in SEC rules which creates a market for rating agencies and gives a certain amount of credibility and stature to ratings that perhaps they don't always deserve.

Senator COLLINS. Thank you. Thank you, Mr. Chairman.

Senator DURBIN. Senator Tester.

Senator TESTER. Yeah. I just do want to get to the CFTC Chairman, but I just want to just close by saying thank you. Thank you for what you've done, thank you for what you're going to do.

I would ask that, you know, as these budgets come forward, 2005 to 2007 budgets were visited about here on a couple different occasions, somebody dropped the ball. Congress probably had a part to do with it. Your predecessor may have had a part to do with it.

But it ended up in a disaster and we need to make sure that you have the resources, no more, no less, but just the resources you need to do your job, and I think that, as a friend of mine pointed out last week, we need to quit thinking in Government in silos, we need to start thinking about the consumer and whoever is consuming that product, whether it's in education or housing or in this case securities, and make sure that Government works for the betterment of everybody.

But I really want to thank you for the work you've done so far. It's very impressive, and I look forward to working with you in the future.

Ms. SCHAPIRO. Thank you very much.

Senator DURBIN. Thank you very much, Senator Tester.

Chairman Schapiro, thank you for your testimony.

Ms. SCHAPIRO. Thank you, Mr. Chairman.

ADDITIONAL COMMITTEE QUESTIONS

Senator DURBIN. We'll be working closely with you and your agency as we put together the appropriation bill.

Ms. SCHAPIRO. Thank you.

[The following questions were not asked at the hearing, but were submitted to the Commission for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

STAYING ON THE CUTTING EDGE OF TECHNOLOGY

Question. With rapid acceleration of electronic innovations in the securities markets, the Securities and Exchange Commission faces the challenge of keeping abreast of advancements. In the face of aggressive efforts of trading firms to invest in new technology, it is critical that SEC investigators understand the nuances of modern trading operations.

Does the SEC have sufficient resources to hire the best and brightest financial technologists?

Have you identified specific gaps in SEC's workforce expertise when it comes to electronic trading?

Answer. As you may know, the SEC has launched a new initiative with existing resources to broaden the skill sets within its workforce, ranging from financial analysis to complex trading strategies. As part of this effort, the SEC is recruiting seasoned industry professionals into our enforcement, examination, and risk assessment programs, through efforts such as the Industry and Market Fellows and the Senior Specialized Examiner programs. The SEC is also implementing enhancements to the SEC's existing training programs, in areas such as the examination program which is enhancing staff expertise in topics such as fraud detection, complex financial products, and trading and where more than a third of the staff have signed up for training to become Certified Fraud Examiners. If Congress were to approve additional resources for the SEC, then the agency would look to expand these recruiting and training efforts very significantly.

A key repository at the SEC for expertise on trading systems is the Automated Review Program within the Division of Trading and Markets. The program conducts examinations of the trading systems of markets and clearing agencies, to assess the data's confidentiality, integrity, and availability. The program has been able to stay on top of this rapidly evolving field, through efforts such as the CYBER CORPS program, which has served as a great resource for identifying talented IT professionals, and through the NSA, which has provided non-commercial software and technical training. Over the past few years, the program has increased its expertise in IT security and launched new initiatives in the areas of cyber security, auditing intermediaries in credit default swaps, and international markets. The Division now plans to implement new source code review of trading systems and more sophisticated penetration testing, to the extent resources are available.

EXPEDITING FAIR FUNDS DISBURSEMENTS

Question. Under the "Fair Funds for Investors" provision (Section 308(a) of Sarbanes-Oxley), the Securities and Exchange Commission is required to return money to investors victimized by securities fraud. Previously, disgorgements and penalties were deposited into a U.S. Treasury General Fund.

Answer. The Fair Funds provisions of the Sarbanes-Oxley Act of 2002 gave the Commission authority to increase the amount of money returned to injured investors by allowing civil penalties to be included in Fair Fund distributions. Prior to Sarbanes-Oxley, only disgorgement could be returned to investors.

Question. What improvements have been realized so far from the creation of a specialized office on "Fair Funds" disbursement?

Answer. The Commission established the Office of Collections and Distributions (OCD) to, among other things, expedite the distribution of Commission recoveries to injured investors. The Office is responsible for overseeing the distribution of funds to investors who have been injured by securities law violations, implementing the Enforcement Division's collections and distributions programs, and conducting litigation to collect disgorgement and penalties imposed in certain Enforcement actions. In addition, the Office tracks, records, and provides financial management assistance with respect to the funds and provides overall case management services for the Division.

The Office has helped streamline the distributions process and enhance its internal controls, and it has overseen the distribution of approximately \$3.2 billion to injured investors to date. Among the Office's recent initiatives has been to issue standardized, step-by-step guidance to enforcement staff on developing and imple-

menting distribution plans in both civil actions and administrative proceedings. In addition, the Office has consolidated collections and distributions information onto the enforcement program's internal website so that is more accessible to staff nationwide. In collaboration with other SEC offices, OCD has created templates to standardize the reporting of periodic and final accountings for distributions of disgorgement funds and Fair Funds, as well as to facilitate the examination of administrative expenses. In order to manage receivership expenses, the Office also developed billing instructions for receivers. OCD conducts training for the staff on the use of both the standardized reports and the billing instructions.

Question. SEC's financial tracking system (Phoenix) was established to improve management of distribution of Fair Funds to victims of securities law violations. Is the "Phoenix" system fully functional at this time? What remains to be done to improve its capabilities?

Answer. To date, the Phoenix system has only been partially deployed. Under the functionalities that are already operational, Phoenix assists with tracking and recording the disgorgement and penalties ordered in Enforcement actions. However, the Phoenix system does not yet track and record distribution information. This function is currently performed in a limited way within CATS 2000, the SEC's case tracking system, which is itself slated to be replaced.

To that end, the agency is developing business requirements for a new module that would record and monitor distribution-related information, including information reported on the newly developed standardized accounting reports. Once fully built, this module would enable the SEC to track a distribution fund's current status or phase in the distribution process, enhance reporting and internal controls over the accuracy and integrity of distribution data, and provide better information about the investment of Commission funds with the Department of the Treasury's Bureau of Public Debt. This effort also will support integration with the agency's core financial management system.

The SEC expects to finalize and deploy the distributions module in fiscal year 2010, depending on the availability of sufficient funding.

Question. I note that SEC is currently reviewing its performance measure of the percentage of Fair Funds and disgorgement dollars designated for distribution to victims within a year. What are the challenges? What is hampering SEC's ability to track the timeliness of the fund distributions and maintain accurate data?

Answer. As noted in the Commission's fiscal year 2010 budget justification, this measure is currently under review and may be adjusted in the future. One of the primary challenges with respect to such a measure has been the SEC's inadequate systems to collect, analyze, and report on distributions (described above), which have hampered the Commission's ability to track the timeliness of the fund distributions and maintain accurate data.

Question. What portion of this year's budget (fiscal year 2009) and the proposed needs for fiscal year 2010 will be devoted to the Fair Funds distribution project?

Answer. The first major expense associated with Fair Funds distributions is information technology, most notably the Phoenix system. In fiscal year 2009, the SEC expects to obligate approximately \$0.1 million in ongoing maintenance and support related to Phoenix. For fiscal year 2010, the agency estimates that distributions-related projects will cost approximately \$3.2 million. These projects include efforts to develop new collections and distributions tracking functionalities, enhance the current Phoenix system, integrate Phoenix with the enforcement program's new HUB tracking system and the core financial system, and conduct ongoing system maintenance.

A second component of the SEC's distributions-related costs is the expense associated with the Office of Collections and Distributions. OCD's costs amount to approximately \$6.0 million in fiscal year 2009 and \$6.2 million in fiscal year 2010. However, it is important to note that the Office performs a variety of functions in addition to distributions, including assisting with collection of delinquent debts and maintenance of internal controls.

The final element is the substantial staff time spent on distributions functions within other parts of the SEC. For example, within the enforcement program (outside of OCD), attorneys spend considerable time on the development, oversight, and implementation of distribution plan actions, while support staff perform data input for all cases. In addition, the SEC's Office of Financial Management aids with funds investment and disbursement, as well as internal controls; the Office of the General Counsel reviews and comments on distribution-related documents; and the Office of Economic Analysis evaluates the methodologies for measuring investor loss. Although the staff time involved is significant, the SEC does not currently track costs at this level.

QUESTION SUBMITTED BY SENATOR BEN NELSON

RULE 151A, ISSUED JANUARY 16, 2009

Question. On January 16th of this year, the Commission issued a new rule regarding indexed annuities and certain other insurance contracts. This rule takes effect on January 12, 2011.

What level of resources will the SEC devote in fiscal year 2010 to preparing to implement this rule? Can you calculate the cost to the Commission of the work necessary to fully implement this rule so that it can be operational on January 12, 2011?

Looking ahead to the next fiscal year (fiscal year 2011), in taking on this additional regulatory responsibility, will additional staff be required? What will additional staff needs and additional regulatory responsibility mean for the Commission's budget?

Answer. The release adopting this rule (Rule 151A) articulated the Commission's determination that investors in certain indexed annuity contracts are entitled to the protections of the federal securities laws. The rule includes a new definition of "annuity contract" that, on a prospective basis, will define a class of indexed annuities that are outside the scope of Section 3(a)(8) of the Securities Act, which provides an exemption under the Securities Act for certain insurance contracts. These indexed annuities will, on a prospective basis, be required to register under the Securities Act. With few exceptions, indexed annuities historically have not been registered as securities. The new definition will apply to indexed annuities that are issued on or after the January 12, 2011, the effective date of the rule.

The staff is currently considering how to tailor disclosure requirements for indexed annuities. As with any other rulemaking, if the staff determines to recommend that the Commission propose new disclosure requirements, resources will be applied to develop a proposal, analyze public comments on the proposal, determine whether to recommend adoption of the proposal and consider whether and how it should be modified to reflect commenters' concerns.

In addition, the Commission encouraged insurance companies, sellers of indexed annuities, and other affected parties to submit specific requests for guidance regarding the implementation of the rule. We anticipate that any responses to such requests will require staff resources.

The Division of Investment Management also anticipates reviewing filings for approximately 400 new indexed annuity contracts in the first year.

In all, the Division of Investment Management believes the implementation of Rule 151A will require an allocation of seven staff positions during the first year, with that number likely to decrease in the years following the initial implementation. The estimated cost of these seven positions is \$1.6 million for fiscal year 2011. As discussed above, these staff will perform further rulemaking as appropriate, provide interpretive advice, and review disclosure filings.

 QUESTIONS SUBMITTED BY SENATOR SUSAN COLLINS

Question. Chairman Schapiro, recently many news outlets have issued stories about the administration's proposal to move some consumer-protection powers outside of the SEC. Reports state that that you are opposed to such a proposal. A May 20th Wall Street Journal article quotes you as saying that such a plan would ". . . be hugely expensive and highly inefficient . . ." Would you discuss your objections?

Answer. I did not believe that investors would be better protected by separating some securities products from others, potentially creating gaps in the regulatory and enforcement regime. Securities products are different from consumer credit products: generally they are not guaranteed and include a number of inherent risks, including the loss of principal. The administration's white paper outlining its consumer protection plan appears to recognize this, and I do not object to that approach.

Question. Secretary Geithner recently laid out a framework for overseeing the derivatives market including rigorous reporting requirements. Such a proposal would give the SEC and CFTC new authorities to regulate derivatives. What are your thoughts on the plan and the role of the SEC in the regulation of derivatives?

Answer. I agree with the Secretary's approach. Both the SEC and CFTC have a role in regulating derivatives products. We continue to work together and make progress on how such a regime might work to best fill gaps in the regulatory framework and prevent regulatory arbitrage. I look forward to working with Congress to make the necessary legislative changes.

Question. Two veteran enforcement lawyers at the SEC are currently under investigation for insider trading. A May 16 Wall Street Journal article quotes a report by the SEC Inspector General saying that “the SEC has ‘essentially no compliance system’ to detect potential insider trading.” As a result of the investigation into the trading activities of the two attorneys, the SEC has proposed the imposition of new rules on employee trades. How does this investigation affect your confidence in the ability of the SEC staff? In your estimation, do the recent troubles at the SEC signify fundamental problems within the organization, and if so how do you propose to rectify the issues?

Answer. I have the utmost confidence in the ability of the SEC’s staff and their unflagging dedication to the protection of investors. Time and time again, I have been impressed by the staff’s talent, integrity, and enthusiasm for the agency’s mission. However, it became clear to me soon after joining the agency that the SEC’s system for ensuring compliance with employee trading rules was not sufficient. The report by the agency’s Inspector General concerning trading activity by certain employees reinforced my belief that the SEC should have a trading compliance system that is second to none.

I know the agency’s staff shares my belief that, in light of the SEC’s mission, it is vital that we conduct ourselves according to the highest standards of ethical conduct when it comes to our own financial holdings and transactions. To that end, we have taken several significant steps to strengthen the SEC’s compliance system and reduce the potential for even the appearance of inappropriate securities trading:

- We have proposed new rules concerning employee trading. These rules will, among other things:
 - Require the pre-clearance of all trades.
 - Prohibit all trading in the securities of a company under SEC investigation, regardless of whether the employee is aware of the investigation.
 - Require all employees to authorize their brokers to provide duplicate trade confirmation statements to the agency.
 - Prohibit the ownership of securities in publicly-traded exchanges and transfer agents, in addition to existing prohibitions against owning securities in other firms directly regulated by the Commission.
 - Require employees to certify that they do not have any non-public information about the company whose securities they are trading.

These rules were submitted to the Office of Government Ethics (“OGE”) on May 22, 2009, and we await OGE’s comments.

- We recently retained an outside firm specializing in automated compliance systems to develop a new computer compliance system for the agency, which will automate and simplify the transaction reporting process and make it easier to verify and monitor employee trading.
- We are creating a new Chief Compliance Officer position, and have already received applications from a number of excellent candidates for the new position.
- I have consolidated responsibility for the oversight of employee securities transactions within the SEC’s Ethics Office and devoted additional staff resources to monitor, review, and spot-check these transactions.

These measures will bolster and modernize the agency’s compliance program, and help the talented and committed staff do its critical work of protecting investors without distraction.

Question. The fiscal year 2010 budget request does not include an increase for the SEC Inspector General. Considering the likelihood of an increased workload at the IG’s office, as the SEC increases surveillance and monitoring of employee trading, do you think that the IG will need additional funds?

Answer. The Inspector General submitted a request for three additional positions only a few days before the publication of the SEC’s Congressional Justification for fiscal year 2010, and therefore these additional positions were not reflected in the document. However, I have since approved the addition of these personnel, which would bring the OIG to a total of 19 positions. When these new staff are combined with the two positions approved for OIG in January 2009, the Office will have grown by a total of 73 percent within this calendar year, which is the highest growth rates of any SEC office during this timeframe.

Question. Please provide a breakdown of the tips and complaints the SEC received in fiscal year 2007 and fiscal year 2008, to help explain the large decline in that year.

Answer. As you mentioned, the number of tips and complaints received by the SEC’s Office of Internet Enforcement declined significantly between 2007 and 2008, from about 1,586,000 to about 615,000 in 2008. Unfortunately, the SEC has not had a tracking system that can break down those figures into their component parts or support rigorous analysis of underlying trends.

The SEC's initiative to bolster its systems for tracking tips and complaints, working with the Center for Enterprise Modernization, will help the agency perform much better analyses in the future. Such analyses will help the SEC understand the overall statistics on tips and complaints and identify trends among specific firms or practices that can provide valuable information for potential enforcement action and compliance exams. The SEC also is working to streamline and standardize the agency's handling of tips and complaints, so they can be addressed more consistently and effectively. Nevertheless, for the 2007–2008 period, the SEC is reliant on anecdotal evidence to explain the decline in tips and complaints during that timeframe.

In general, the number of complaints the agency sees is related to the volume of spam and commercial email traffic received by investors. A number of factors likely affected this volume during the 2007–2008 timeframe. First, the SEC's initiative starting in 2007 to combat spam-driven stock manipulations was reported to have been a major contributor to reducing the amount of spam.¹ Under this initiative, the SEC suspended trading in the securities of dozens of companies that had been the subject of spam stock promotions and initiated several spam-related enforcement actions. According to a private-sector Internet security report, a 30 percent decrease in stock market spam “was triggered by actions taken by the U.S. Securities and Exchange Commission, which limited the profitability of this type of spam . . .”²

Another major factor is the growing use and sophistication of commercial-grade spam email filters, blacklists, and experimental “data mines,” which radically diminish the number of mass investment solicitations received by the average investor. Additionally, tough state and federal anti-spam laws, and high-profile prosecutions under those laws, likely helped to deter spammers.³

General market conditions also likely played a role in the decline in tips and complaints. Email stock promoters' activities lend themselves best to the promotion of obscure, thinly-traded stocks, such as the tech stocks that flourished during the late 1990s market “bubble.” Since the collapse of that bubble, it seems fewer investors have been interested in these microcap stock promotions.

It is important to note that, while the number of tips and complaints went down significantly in 2008, the figure is still 146 percent higher than it was 5 years previously. By comparison, the number of full-time equivalents in the SEC's enforcement program increased by only 23 percent during that period. Also, while the quantity of complaints the SEC received decreased between 2007 and 2008, the SEC believes that the quality of complaints has increased dramatically. Thus, the agency's workload from these complaints has actually become greater over the past year, despite the reduced number of complaints relating to spam.

ADDITIONAL SUBMITTED STATEMENT

[CLERK'S NOTE.—The subcommittee has received a statement from the Investment Company Institute which will be inserted into the record at this point.]

¹“SEC makes inroads against financial spam; Crackdown pays off as e-mail campaigns slow,” by Matt Krantz, USA Today, Oct. 5, 2007 at p. 7A.

²http://eval.symantec.com/mktginfo/enterprise/white_papers/ent-whitepaper_internet_security_threat_report_xii_09_2007.en-us.pdf. Copyright 2007 Symantec Corporation. All rights reserved. Symantec, the Symantec Logo, BugTraq, Symantec Brightmail AntiSpam, and Symantec DeepSight are trademarks or registered trademarks of Symantec Corporation or its affiliates in the United States and other countries. Apple, Mac OS, and QuickTime are trademarks of Apple Inc., registered in the United States and other countries. Safari is a trademark of Apple Inc. Microsoft, ActiveX, Windows, and Windows Media are either registered trademarks or trademarks of Microsoft Corporation in the United States and/or other countries. Sun, Java, and Solaris are trademarks or registered trademarks of Sun Microsystems, Inc. in the United States and other countries.

³See http://www.msnbc.msn.com/id/18955115/arrest_of_Robert_Alan_Soloway/; <http://www.sophos.com/pressoffice/news/articles/2008/02/japan-spam.html> (Yuki Shiina); http://spamkings.oreilly.com/archives/2006/03/stock_spammers_stung_by_secret.html (“g00dfellas” spam gang).

PREPARED STATEMENT OF THE INVESTMENT COMPANY INSTITUTE

The Investment Company Institute¹ appreciates this opportunity to submit testimony to the Subcommittee in support of the administration's fiscal year 2010 appropriations request for the Securities and Exchange Commission (SEC). We commend the subcommittee for its consistent past efforts to assure adequate resources for the SEC. For the reasons expressed below, we urge Congress to provide appropriations at least at the funding level requested by the President.

As SEC Chairman Mary Schapiro noted in her testimony, the recent financial crisis has served as a reminder of the importance and interconnectedness of the securities markets to our nation's economy and the financial health of millions of Americans. The crisis also demonstrated that the current regulatory system is not up to the challenges posed by modern financial markets and needs to be significantly strengthened and modernized. It has led to broad support for reform of the U.S. system of financial services regulation, including numerous calls for Congress to close regulatory and disclosure gaps to ensure appropriate oversight with regard to hedge funds, derivatives, and municipal securities. Toward these ends, it is critically important to provide the SEC with the resources necessary to assure its ability to soundly and effectively regulate securities offerings, market participants, and the markets themselves. And, to the extent that the scope of the agency's responsibilities is expanded with respect to hedge funds, derivatives, and/or municipal securities, it will be imperative that it have sufficient staffing and resources to effectively perform all of its oversight functions.

More generally, the ongoing policy discussions about regulatory reform have highlighted why adequate funding for the SEC should continue to be a Congressional priority. Unlike other financial regulators, the SEC is specifically charged with protecting investors. The agency seeks to fulfill this mission in many different ways, including through the disclosure and substantive rules it adopts and administers, through examinations of regulated entities, and through its enforcement program, to name a few. In the wake of the financial crisis, it is essential to provide the SEC with the resources it needs to successfully pursue its investor protection mission.

Mutual funds and other registered investment companies have a strong stake and vested interest in having a well-funded and effective SEC. Registered investment companies are an integral part of our economy. They represent, as a whole, the largest group of investors in U.S. companies, holding 27 percent of the outstanding stock in U.S. companies at year-end 2008. Registered investment companies also held the largest share of U.S. commercial paper—an important source of short-term funding for major U.S. and foreign corporations. In addition, they continue to be one of America's primary savings and investment vehicles for middle-income Americans. Today, over 93 million investors in more than 53 million U.S. households own shares of registered investment companies; the median household income of these investors is \$80,000. And, since 1990, the percentage of U.S. retirement assets held in mutual funds and other registered investment companies has more than quadrupled. These millions of Americans continue to recognize that mutual funds are the best means of achieving their long-term financial goals. They deserve and benefit from continued vigilant regulatory oversight of mutual funds and other registered investment companies.

The administration's fiscal year 2010 budget proposes SEC funding at a level that represents a 7 percent increase over fiscal year 2009. Chairman Schapiro explained in her testimony that this would permit the SEC to fully fund an additional 50 staff positions over 2008 levels, enhance its ability to uncover and prosecute fraud, and allow it to begin to build desperately needed technology. More specifically, Chairman Schapiro stated that the additional funding would allow the SEC to hire seasoned industry professionals and market experts to strengthen and expand the SEC's Office of Risk Assessment, improve its examination program, and bolster its oversight of the investment management and broker-dealer industries. We have strongly supported precisely these types of measures.² It is essential that the agency

¹The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$10.18 trillion and serve over 93 million shareholders.

²See Letter to The Hon. Mary L. Schapiro from Paul Schott Stevens dated February 18, 2009 (attaching recommendations for SEC priorities under Chairman Schapiro's leadership). See also *Financial Services Regulatory Reform: Discussion and Recommendations*, which is available at http://www.ici.org/pdf/ppr_09_reg_reform.pdf. Chairman Schapiro also noted in her testimony that she intends to improve the overall management of the SEC, including by hiring a Chief

have greater ability (and resources) to attract and retain professional staff having significant prior industry experience. Their practical perspectives would enhance the agency's ability to keep current with market and industry developments and better understand the impact of such developments on regulatory policy. The new Industry and Market Fellows Program is an encouraging step in the right direction, but we also believe that the agency should build strong economic research and analytical capabilities and should consider having economists resident in each division.

We are particularly pleased that a key strategic priority for the SEC's Division of Investment Management will be to strengthen and improve the money market fund regulatory regime. Last November, we convened a high level industry working group to study the money markets. In March, the group made a series of comprehensive recommendations that responded directly to weaknesses in current money market fund regulation, identified additional reforms that will improve the safety and oversight of money market funds and position responsible government agencies to oversee the orderly functioning of the money market more effectively.³ We look forward to working with the SEC on this critically important issue.

In conclusion, the SEC and the fund industry share a common objective of assuring that mutual funds remain a vibrant, competitive and cost effective way for average Americans to access the securities markets and realize their long-term financial goals. Future regulatory and oversight actions by the SEC will play a key part in this process. It is therefore critically important that the SEC have sufficient resources to adequately fund the staffing of the agency and to take other steps to fulfill its mission of protecting the nation's investors, including the over 93 million Americans who own mutual funds. Accordingly, we urge Congress to provide appropriations at least at the funding level requested by the President.

We appreciate your consideration of our views.

Operating Officer to manage the organization. We also supported this idea in both our February 18, 2009 letter to Chairman Schapiro and *Financial Services Regulatory Reform* white paper.

³See *Report of the Money Market Working Group*, submitted to the Board of Governors of the Investment Company Institute on March 17, 2009, available at http://www.ici.org/pdf/ppr_09_mmwg.pdf.

COMMODITY FUTURES TRADING COMMISSION

STATEMENT OF HON. GARY GENSLER, CHAIRMAN

Senator DURBIN. I'd like to invite Chairman Gensler from the Commodity Futures Trading Commission to come forward.

This year, 2009, marks the 35th year since the establishment of this agency. At this time of its inception in 1974, CFTC's 500 employees were tasked with ensuring fair practices and honest dealings on the commodity exchanges of America's then \$500 billion industry in 1974.

Today, it is a \$22 trillion industry and it looks a lot different. The traditional agricultural products are still there, but the landscape has been diversified with novel and complex commodities, from grains to gold, currencies to carbon credits.

In the past decade trading volume has increased more than tenfold, reaching over 3.4 billion trades in 2008. Actively traded contracts have quintupled from 286 in 1998 to 1,521 in 2008.

CFTC oversees \$5 trillion of trades every single day. So we don't want you to stay at the table too long. We want you to get back and keep an eye on those trades, but we invite you, Chairman Gensler, to give your testimony at this point.

Mr. GENSLER. Thank you, Chairman Durbin, Ranking Member Collins, and members of the subcommittee, Senator Tester.

I'm pleased to be here today to discuss our budget and especially pleased to learn that Senator Durbin recently visited our Chicago office which very encouraged the staff and I thank you for it.

I'm also grateful to each of you for your individual support on my recent confirmation. It's an honor to serve the country in this capacity.

I come before you having served as Chairman just 6 calendar days, but with full knowledge of the failures of our regulatory system, failures that affected all Americans, failures that we must ensure do not happen again, and as Chairman, I will use every authority available to protect the American people from fraud, manipulation, and excessive speculation.

I will also work with Congress on new authorities to bring much-needed transparency and regulation to the over-the-counter derivatives marketplace.

I am grateful on behalf of the agency for the \$146 million recently appropriated for this Commission. This boost has allowed us to get back to beginning to address the alarmingly low staffing levels there are at the agency. Our size, however, is still roughly equivalent to the Commission that was established 35 years ago.

Today, the futures market is dramatically different, as Chairman Durbin just outlined, being some 45 times larger than it was 35 years ago, and much more complex as well.

Just 10 years ago the CFTC was near its peak staffing levels, near 580 full-time equivalents. It's shrunk over 20 percent in the

past years, but with your help the fiscal 2009 funding will permit us to get back to where we were in 1999.

Since 1999, however, volumes have gone up fivefold, the number of contracts have gone up sixfold. The complexity, of course, I don't need to tell you, has gone up dramatically. We've gone from open outcry pits to electronic trading which is in some cases harder to monitor. We've also lived through the worst financial crisis in 80 years and seen the results of an asset bubble in commodity prices.

In short, the Commission remains an underfunded agency and we're very grateful to the President's budget of \$160.6 million in recognition of some of these needs. If I could just share with you some of the things that have been highlighted to me in my first 6 days. I think we still need to ensure that our enforcement effort is larger to ensure robust enforcement of our laws. Currently, we have about 141 attorneys in our Enforcement Division. I believe this is still quite lower than what's required, given the financial turmoil we've lived through.

We must ensure greater transparency. I believe that commodity index funds did contribute to the asset bubble that we've just lived through. To bring greater transparency will require more economists. It's going to require announcements in our weekly commitments in traders' reports. We'll also need to upgrade our systems as well.

We must ensure that position limits consistently applying across the board, and that we're reviewing hedge exemptions and no action processes in that regard.

Our information technology (IT) systems and particularly our mission critical systems on positions and transactions have not been upgraded for quite some time and I've looked forward to working with this subcommittee on getting funds to try to upgrade these mission critical systems.

And also, we need to ensure timely review of new products and rule change filings. This has lagged a great deal and just last year with the new farm bill, the review of significant price discovery contracts will be important moving forward.

These are only a few of the funding priorities, but I wanted to give the subcommittee a tangible sense of some of the things that we're grappling with and struggling with.

With that in context, the \$14.6 million of additional funding, about one-half of that is to stay at current services and one-half of that in the President's budget, fortunately, is for 38 new full-time equivalents to bring us back just above where we were 10 years ago, to about 610 full-time equivalents. These positions are essential. The increase, however, still won't allow us to fully address these complex markets and what we need to do.

Before I close, I would like to highlight that the additional funding needs will also accompany much-needed regulatory reform. I, along with other regulators, and the administration feel we need to broaden reforms in the over-the-counter derivatives marketplace and bring it all under the regulatory umbrella. I look forward to working with this subcommittee and Congress for funding those new authorities to make sure they're properly implemented.

PREPARED STATEMENT

And with that, I thank you very much and I look forward to answering your questions.

I hope my written testimony can be entered into the record.
 Senator DURBIN. Of course. It will be.
 [The statement follows:]

PREPARED STATEMENT OF GARY GENSLER

Thank you, Chairman Durbin, Ranking Member Collins, and other members of the Subcommittee. I am pleased to be here to testify on behalf of the Commodity Futures Trading Commission, and I appreciate the opportunity to discuss issues related to the Commission's 2010 Budget. I am also grateful to have had each of your individual support for my recent confirmation. It is a great honor to serve my country in this capacity.

I come before you today having only served as CFTC Chairman for 6 calendar days, but with the full knowledge of the failures of our financial regulatory system; failures that affected all Americans and failures that we must ensure never occur again.

The last decade, and particularly the last 21 months, has taught us much about the new realities of our financial markets. We have learned the limits of foresight and the need for candor about the risks we face. We have learned that transparency and accountability are essential and that only through strong, intelligent regulation can we fully protect the American people and keep our economy strong.

As Chairman of the CFTC, I will use every tool and authority available to protect the American people from fraud, manipulation and excessive speculation. I also look forward to working with Congress to establish new authorities to close the gaps in our laws and bring much-needed transparency and regulation to the over-the-counter derivatives market. I firmly believe that doing so will strengthen market integrity, lower risks, protect investors, promote transparency and begin to repair shattered confidence in our financial markets.

I would like to thank the Committee for the \$146 million recently appropriated for the CFTC for the 2009 fiscal year and special thanks to Chairman Durbin for visiting our Chicago office last year. As a result of this much needed boost in funding, the Commission has begun to address our alarming staffing levels; levels that recently reached historic lows.

At present, the Commission employs about 500 career staff—roughly equivalent to when the Commission was created in 1975. Three decades later, the futures market has changed in every way: with respect to volume, complexity, risk and locality. What was once a group of regional domestic markets trading a few hours 5 days a week is now a global market trading 24/7, and what was once just a \$500 billion business has exploded to a \$22 trillion annual industry.

Ten years ago, the CFTC was near its peak staffing level at 567 employees, but shrunk by 20 percent over the subsequent 8 years before hitting a historic low of 437.

With the increase in fiscal year 2009 funding the CFTC can reach 572 employees.

While this is a start, I believe that merely raising our staffing levels to the same as a decade ago will not be enough to adequately fulfill all of the agency's missions. In the last 10 years, trading volume went up over five fold. The number of actively traded futures and options contracts went up over six fold, and many of these are considerably more complex in nature. We also moved from an environment with open-outcry pit trading to highly sophisticated electronic markets.

In addition to the dramatic evolution of the futures industry, we have experienced the worst financial crisis in 80 years. We also experienced, in my view, an asset bubble in commodity prices. The staff of the CFTC is a talented and dedicated group of public servants, but the significant increase in trade volume and market complexity, as well as rapid globalization, commands additional resources to effectively protect American taxpayers.

For all of these reasons, I feel it is appropriate for our staffing levels and our technology to be further bolstered to more closely match the new financial realities of the day.

In short, despite the recent increase in funding, the Commission remains an underfunded agency. The President's Budget recommendation of \$160.6 million is recognition of this need. Specifically, the Commission needs more resources to hire and retain professional staff and develop and maintain technological capabilities as sophisticated as the markets we regulate.

I'd like to identify some of my priorities and provide some illustrations of how resource limitations have constrained the Commission. Among my priorities will be to:

- Ensure robust enforcement of our laws. Currently, the Commission's enforcement program consists of 122 employees—the lowest level since 1984. Though fiscal year 2009 funding will get us back to 141 enforcement employees, this is still below the agency's peak of 167 and well below what we need given the current financial turmoil. Any financial downturn reveals schemes that could only stay afloat during periods of rising asset values. Our current, and much larger, downturn is exposing more leads than the Commission can thoroughly and effectively investigate. This is true both as it relates to fraud and Ponzi schemes as well as staff intensive manipulation investigations. The regulations we enact to protect the American people are meaningless if we do not have the resources to enforce them;
- Ensure greater transparency of the marketplace. Also, I believe that commodity index funds and other financial investors participated in the commodity asset bubble. Notably, though, no reliable data about the size or effect of these influential investor groups has been readily accessible to market participants. The CFTC could promote greater transparency and market integrity by providing further breakdowns of non-commercial open interests on weekly "Commitments of Traders" reports. The American public deserves a better depiction of the marketplace. The temporary relief from higher prices does not negate this need, especially given that a rebounding of the overall economy could lead to higher commodity prices;
- Ensure position limits are consistently applied. The CFTC has begun a review of all outstanding hedge exemptions to position limits. This review will consider the appropriateness of these exemptions and look for ways to institute regular review and increased reporting by exemption-holders. The Commission also has begun a review of the process and standards through which no-action letters are issued. As part of these reviews, CFTC staff will consider the extent to which swap dealers should continue to be granted exemptions from position limits;
- Ensure the Commission has the tools to fully monitor the markets. We must upgrade the Commission's mission critical IT systems for the surveillance of positions and trading practices. Neither is robust enough nor have they been upgraded to reflect the vast increase in volume and complexity. Our systems must begin to produce the surveillance reports needed to meet the analytical needs of our professional staff and the transparency needs of the public; and finally
- Ensure timely reviews of the many new products and rule change filings of the futures markets. These have lagged due to the growth and complexity of markets and the added responsibilities extended to the Commission in the 2008 Farm Bill. The Farm Bill requires staff to review all contracts listed on Exempt Commercial Markets (ECMs) to determine if they are significant price discovery contracts—if they are, then any ECM that lists such a contract must also be reviewed to determine compliance with a stringent set of core principles under the Commodity Exchange Act.

Other examples that I believe are illustrative of the difficult tradeoffs caused by resource constraints are:

- The Commission does not conduct annual compliance audits of every Designated Contract Market (DCM)—rather only periodic reviews on average, every 3 years;
- The Commission does not conduct annual compliance audits of every Derivatives Clearing Organization (DCO)—rather periodic reviews are conducted of selected core principles that are rotated and completed every 3 years; and
- The Commission does not conduct routine examinations of Commodity Pool Operators, Commodity Trade Advisors, and Futures Commission Merchants—a function currently performed by Self Regulatory Organizations. If the Commission were to perform direct periodic audits our staff would better understand the operations of brokers and managed funds and could better assess compliance with the law and regulations.

These are only a few of our important funding priorities and the workload challenges imposed by resource limitations. There are, of course, others. I hope that this helps the Committee to understand, in a tangible way, the challenges the Commission faces in regulating the futures markets the way the Nation requires.

Although the work of the Commission can be highly technical in nature, the mission of the agency is quite straightforward. The CFTC is charged with:

- Protecting the public and market users from manipulation, fraud, and abusive practices and
- Promoting open, competitive and financially sound futures markets.

With that context, I would like to address the specifics of the fiscal year 2010 Budget request. The fiscal year 2010 Budget proposes an increase of \$14.6 million. Approximately half of the increase is needed to maintain our fiscal year 2009 level of operations into fiscal year 2010. The balance would fund an additional 38 positions.

Twenty-six of the 38 staff would be allocated to principal program areas. Specifically, we would allocate 11 positions to Enforcement, 8 to Market Oversight, 6 to Clearing and Intermediary Oversight, and 1 to the Chief Economist's office. The remaining 12 positions will provide critical mission support in the areas of legal analysis and counsel, technology support, international coordination, legislative and public outreach, and human capital and management support.

The additional 38 positions are essential to addressing some of the limitations I mentioned earlier. This increase, however, will not provide the Commission with the critical mass of professional and technical expertise needed to ensure that the growing markets remain free of manipulation and fraud.

For example, our enforcement staff needs to be significantly expanded to:

- Ensure that crimes are punished to the fullest extent of the law;
- Develop strategies aimed at quickly identifying and eradicating fraudulent schemes, such as Ponzi and foreign exchange “boiler rooms”; and
- Importantly, pursue resource-intensive investigations and litigations involving manipulation, including energy-related market abuses, so wrongdoers will not believe they are immune from enforcement simply due to the complexity of an enforcement action.

Insufficient resources in the enforcement division force it to be too selective in the matters it investigates.

Our market oversight operation needs additional highly-skilled economists, investigators, attorneys and statisticians to:

- Analyze trading reports quickly and thoroughly, identify potential market problems or trader violations promptly, and avoid market disruptions and pricing anomalies;
- Conduct timely and complete reviews of regulated entities to ensure compliance with all core principles;
- Examine exchange self-regulatory programs on an on-going and routine basis with regard to trade practice and market surveillance; and
- Ensure their compliance with disciplinary, audit trail, record-keeping and governance obligations.

Our clearing and intermediary oversight program needs additional auditors, analysts, and attorneys. This would allow us to:

- Ensure clearing systems protect against a single market becoming a systemic crisis;
- Protect investors' funds from being misused or exposed to inappropriate risks of loss; and
- Guard against abusive sales practices that harm customers and undermine market integrity.

Our economic research program needs more economists to review and analyze new market structures and off-exchange derivative instruments, especially in light of novel and complex products and practices that call for state-of-the-art economic analysis. Further, additional resources would enhance our economic and statistical analysis, improving transparency of markets and better supporting the Commission's enforcement and surveillance programs.

We also need to transform the current legacy information technology systems into robust systems capable of efficiently receiving and managing massive amounts of raw data as well as transforming them in to useful analytical and research tools.

The Commission has made a substantial investment in technology over the past 2 years—focusing first on upgrading obsolete computer hardware to industry standards. We need technology, however, that is as modern and dynamic as the technology-driven markets we are charged with overseeing. Our investment in technology must be more than just periodic equipment upgrades and maintenance. The Commission must leverage resources by employing 21st century technology to protect the American people.

As the Commission informed this Committee in February of this year, the agency believes it needs \$177.7 million for fiscal year 2010 to perform its present duties. I look forward to working with this Committee to secure the funding necessary to meet our current regulatory responsibilities.

Before I close, I would like to briefly highlight funding needs that might go along with much needed regulatory reform. The CFTC along with the administration and other financial regulators is committed to working with Congress on broad regu-

latory reform. This is particularly true for the markets that the CFTC currently regulates and the markets that may soon come under our regulation.

Specifically, we must urgently regulate the over-the-counter derivatives market and address excessive speculation through aggregated position limits.

President Obama has called for action by the end of this year to strengthen market integrity, lower risks, and protect investors. The future of the economy and the welfare of the American people depend on a vibrant Commission to assist in leading the regulatory reform ahead. Additional funding will be necessary to properly implement these reforms.

I look forward to working with the Members here today and others in Congress to accomplish this goal.

Thank you very much. I would be happy answer any questions you may have.

STAFFING

Senator DURBIN. Chairman Gensler, thank you for being here and we're glad that you're on the job, and it strikes me that if we look at your recent arrival and the recent arrival of a lot of money into your agency, that you're really going to be tested quickly in terms of whether or not you can gather together the professional staff to do your job and the added responsibilities that you mentioned in the farm bill. I don't know if you have had a chance to look at the inspector general's report on your agency but that was, I think, one of the major points made by that report, as to whether or not you would have the human capital necessary to monitor the complex situations that you face.

Now, there's been some problems in the past at CFTC when it comes to Federal pay parity, where the Government basically said let's start treating all the professionals in our agencies alike and CFTC seemed to be lagging in the past in bringing the income levels up to meet the pay parity standard.

You mentioned my visit to the office in Chicago and I'm glad I did it. I don't know how many other Congressmen or Senators have been there, but it's an eye-opener. It's a small staff but it's an amazing staff and I was very impressed. There are some people we have working for our Government in that office who do such exceptional work.

One man they introduced me to, I've forgotten his name unfortunately, and they told me what his responsibility was each day and they said he is the go-to guy. He watches all of these transactions going and he's the one who monitors them and if he weren't here, you know, I'm not sure how good a job we'd do. It would take a lot more people to try to do what he does every day. I said, "Does this man take a vacation?" They said, "Yes, he does and we try to hang on until he gets back."

It's that kind of person and that kind of responsibility which leads me to ask, now that we've sent you a substantial amount of money in this year's fiscal year bill, in the omnibus bill, and now that we've told you you need more professional people and now that you're looking at this pay parity issue, how are you trying to fit these pieces together into some coherent way of expanding your agency in a manner that is consistent with rewarding the good performance of people there and bringing onboard the kind of folks that you need to meet these new electronic markets?

Mr. GENSLER. Senator, I think you're right in these are important challenges. Just being in the job for 6 days, what I see are talented staff facing significant challenges ahead.

Senator DURBIN. Incidentally, you're new to this, but it's always great to start your answer with Senator, you're right. Please proceed.

Mr. GENSLER. Senator, you're right. As I understand it, the agency's been able to fulfill all of the job postings—about 95 job postings. There's confidence, at least within the staff, as to what might be achieved by September 30. We all know there's a summer and August and so forth, but all the postings are up. Some of the recruiting has already occurred and people have been coming in.

But I also agree with Chairman Durbin that this agency, which was so sorely underfunded and actually shrank over 20 percent in the face of this complexity during the last 8 years, has too many jobs that are being done by one person or not enough. As an example, when I asked, well, how large is the group that oversees clearing, this really important function in futures. I was told that there is a nine-person staff out in Chicago, which is part of that larger staff, I said, "Is that enough?" Well, you know, everybody said, "Well, that's what we have. We've had to make tough choices."

So I think that's very important. I'm committed to make sure that taxpayer dollars are put to work most appropriately and efficiently, but I do have confidence in what I've seen in 6 days, that there's a plan of action for these hires.

Senator DURBIN. What about the pay parity issue?

Mr. GENSLER. On pay parity, as I understand it, we've been able to bring up to a figure of about \$4 to \$4.5 million.

Senator DURBIN. I might say that there—

Mr. GENSLER. I'm sorry Senator, let me just correct this. There is \$1.4 million in the fiscal 2010 budget specifically with regard to that.

STUDENT LOAN REPAYMENT

Senator DURBIN. One obscure little thing which I accomplished when Senator Collins was chairing the Governmental Affairs Committee.

Senator COLLINS. Governmental Affairs.

Senator DURBIN. Governmental Affairs Committee, when it started, was the whole question of student loan repayment as an incentive to bring in professionals to Federal agencies.

The SEC is one of the best agencies in Government on this front, 385 of their staff, 181 of whom are attorneys have used the student loan repayment, and I believe this brings them into Federal Government where their services are very valuable. Otherwise they might not be able to consider it.

CFTC has not instituted such a program, probably for lack of money, and I'm wondering if you expect to be able to provide that benefit as part of recruitment in the future.

Mr. GENSLER. The answer is yes, sir, I think that we tried to do—I think it was just a small amount this year, \$200,000 in this fiscal year.

Senator DURBIN. I see.

Mr. GENSLER. In fiscal 2009, actually.

Senator DURBIN. Well, I think it can be a major part of attracting really talented college graduates who otherwise would be lured to something that may pay a little more just to defray their costs.

Mr. GENSLER. The agency shares that view.
 Senator DURBIN. Thank you.
 Senator COLLINS.

UNDERFUNDING

Senator COLLINS. Thank you, Mr. Chairman.

Mr. Gensler, Senator Lieberman and I, as the chairman and ranking member of the Homeland Security and Governmental Affairs Committee, held three hearings last year looking at speculation in the commodities markets, and I want to talk about some of our findings as a result of those hearings.

The first we've already discussed at some length and that is that the CFTC has been woefully understaffed. We were told by the Commission that there were more than 3 billion futures and options contracts that were traded last year, I guess it would have been the year before last, and that was up from 37 million in 1976 when the Commission was first created, so 37 million to 3 billion contracts, and yet the Commission was operating with fewer employees than it had 30 years ago. Just an untenable situation.

Now, the Acting Chairman of the Commission in February wrote to the Office of Management and Budget (OMB) Director in protest of the budget that had been handed down by OMB of having a budget of \$160.6 million and he described it as perilously inadequate. He went on to say that it would not allow the Commission to implement all of its responsibilities. That is the budget that we're talking about today.

Do you disagree with the letter that was written by the Acting Chairman or do you share his concerns?

Mr. GENSLER. I share the concerns that this agency is both underfunded, as you and Senator Lieberman's panel determined last year. I think, as the Acting Chairman Mike Dunn did an excellent job these past 4 months laying out that this agency needs more. We're very appreciative of the President's budget and the 38 additional employees, but I don't think it's really yet up to the task that the American people expect or how we're going to protect against fraud, manipulation, and, as your hearings looked at, the burdens of excess speculation in these markets.

SPECULATION

Senator COLLINS. Let me turn to the speculation issue. As a result of the hearings that we held, Senator Lieberman and I introduced a bill that directed the CFTC to establish position limits that would apply to an investor's total interests in a commodity, regardless of whether they originate on a regulated exchange, the over-the-counter market or on foreign boards of trade that deal in U.S. commodities.

Do you support establishing position limits, having the Commission do it rather than the exchanges?

Mr. GENSLER. I think, Senator, that it's important that we bring a broader view of this even than was being discussed then, that we have the over-the-counter derivatives marketplace under regulation, but, in addition, that the position limits that are set—for instance, if it was for crude oil, that it would look across markets and aggregate not only internationally, as you were discussing, but also

with the over-the-counter derivatives marketplace. There may be contracts that are really quite similar, as you addressed in the farm bill, but more broadly as we work with Congress later this year and try to get aggregate position limit authority for Federal regulators to look across markets and across futures and swaps.

INDEX TRADERS

Senator COLLINS. What our hearings demonstrated was that speculation in the commodities markets by noncommercial investors, not individuals or entities that are actually taking possession of the commodity at some point, but entities, like pension funds, university endowments and other institutional investors, has grown enormously from 2003 to 2008.

In just that 5-year period the total value of their futures contract and commodity index funds investments soared from \$13 billion to \$260 billion. So you have this influx of money from speculators. There's always been speculation in the commodities futures markets.

I understand that and I understand that speculation is useful for hedging risk, but we're talking now about speculation from individuals who are not the traditional buyers and sellers of the commodity, and I understand that those investors' intention is to provide good returns as a hedge against inflation, asset diversification, but the effect of that activity cumulatively appears to drive up the price for some of the traditional users of the commodity markets.

Just a week ago Maine's fuel dealers were in my office saying that they believe excessive speculation by noncommercial players is once again driving up the cost of oil. That's a tremendous issue in a State where 80 percent of the families use home heating oil to stay warm.

So two questions. First, what is your general opinion on whether the influx of funds from nontraditional players is putting artificial price inflation or causing prices to go up beyond what they otherwise would, and second, what, if anything, should we do about it?

Mr. GENSLER. Two excellent questions. I do think that, looking back, in that period that you named and when oil prices peaked last summer, that a contributing factor, not the only factor because there were many factors, but a contributing factor to the commodity asset bubble was index investors and other financial investors.

We have also lived through other asset bubbles in housing, unfortunately, in the stock market in the late 1990s and then again maybe last year. So in a similar way, I think financial actors contributed to this but were not the only cause.

I do think that the Commodity Futures Trading Commission, at its core and has been for 70 plus years, one of its missions is to make sure that markets' integrity is sound, that there's not manipulation and fraud but also that the burdens of excessive speculation be guarded against through position limit authority.

So in terms of that mission, the Commodity Futures Trading Commission is not a price-setting agency, but it is an agency that has to guard to make sure that the markets are operating free of manipulation, free of fraud, and that through the position limit au-

thority the Congress first granted back in the 1930s, that there's some limit to the actors within the marketplace.

Senator COLLINS. Thank you.

Senator DURBIN. Senator Tester.

Senator TESTER. Thank you, Mr. Chairman, and thank you for those questions, Senator Collins.

I've just got a follow-up that goes right under her question and that is, do you think the marketplace right now is being impacted by—I'm talking about the oil marketplace is being impacted by trading of nontraditional traders?

Mr. GENSLER. Senator Tester, again I've only just been in the job for 6 days and mostly been preparing for this Appropriations hearing and a hearing for Thursday on other matters, so I haven't formed a view.

I do think that, just as the asset bubble broke last year with this financial crisis, that part of what we're seeing is with some confidence coming back in the stock market and in other investment markets, just as Senator Collins mentioned, some investments of firms and others are having more confidence in the value in the commodities marketplace.

But again, I've only been there 6 days and haven't, you know, been able to meet with economists and sort through the specifics of this market.

It is likely that, as economy—if we're able to get out of this recession and get away from the financial crisis, the commodity prices will move and I'm not saying where, but a lot will change in the economy, as well.

Senator TESTER. Being a farmer, I don't mind having commodity prices go up. I can tell you that the price of gasoline at the pump in Montana over the last 6 weeks has probably went up a buck a gallon. I don't see that kind of increase at the barrel level. I can still hear about ships floating around out in the ocean full of oil.

I can't make any sense of what's going on and what further frustrates me is that last year, during the last Congress, we had people in, and you're right, it was a multifaceted thing, but very, very few people would step up to the plate last year and say part of this—a good part of this is caused by speculation in the marketplace.

It was all supply and demand, supply and demand, supply and demand, and that was part of it, but I think a good part of it was just flat speculation and greed.

Mr. GENSLER. Senator Tester, as I just mentioned to Senator Collins before you arrived, I believe that index investors, hedge funds, and other pension and financial investors were a contributing factor in this asset bubble of last year. I just haven't been able to tease out exactly what's happened in my first 6 days.

Senator TESTER. I look forward to further communication, either in committee or outside the committee, on that issue because I think it's really important. I think it's really important that we make sure that we have honest markets here.

Mr. GENSLER. I fully agree with that.

MERGER

Senator TESTER. Okay. I asked a question to Secretary Schapiro about the discussions of future roles of your agency and the SEC

as we conduct a regulatory modernization effort, if they were combined, if CFTC were combined with SEC.

Can you just tell me some of the challenges, opportunities, possible consequences?

Mr. GENSLER. You said if.

Senator TESTER. That's right.

Mr. GENSLER. Well, thank you for your question, Senator. I think whether it's in Government or in commerce, it's important to consider that a merger just for merger's sake is probably not much reason to do that, whether it's in Government or in commerce.

Senator TESTER. Yeah.

Mr. GENSLER. I think some of the challenge is that each of these agencies, agencies that date back to the 1930s, have a mission to protect against fraud manipulation but with different missions.

At the CFTC, its core was around farmers and ranchers, which you know a great deal about, to protect their markets so they can hedge a risk, buy the seed and plant a crop knowing that the market pricing mechanism is honest.

That's at the core of the CFTC and if, for any reason, Congress and the President working together wanted to merge these agencies, which again I'm saying merger for merger's sake probably isn't it, we'd have to really protect that root mission, that we're protecting the pricing mechanism for farmers, ranchers, commercial users, all the users of the futures and derivatives marketplaces that the CFTC oversees.

Senator TESTER. Okay. If the President's working group recommends combining the two agencies, if again, and you believe that they should be separated, would you support the working group's regulatory modernization proposal?

Mr. GENSLER. I chair an independent regulatory agency. My responsibility, I think, to the American public would be to tell you what I believed at that time. So I think I would speak out openly and share with this subcommittee and the rest of the Congress what I thought.

DERIVATIVES REGULATION

Senator TESTER. All right. Good. Derivatives. You've been involved in a conversation on regulating or deregulating derivatives for over a decade in past positions that you've held.

Could you give me a quick synopsis, because I'm already out of time, on how your opinion of derivatives and the regulation has evolved over the last 5 to 10 years?

Mr. GENSLER. It has evolved, Senator. I think now that we must bring under regulation the over-the-counter derivatives marketplace through two complementary schemes.

One is the dealers or institutions that actually deal in these swaps, if I may call them, and that's nearly 100 percent of the market, probably in 20 or 25 big institutions. We know their names and you're familiar with them.

We should police for fraud manipulation. We should get 100 percent of the record, both for standardized and customized swaps and set capital standards at the Federal level and margin requirements through the dealer side.

But, in addition, in an additive way, also regulate the markets and then we can lower risk, we can lower risk if we have standard products go through central clearing and we can promote transparency and this is critical that we promote transparency through having regulated exchanges, as well.

Senator TESTER. Okay. Thank you very much, Mr. Chairman.

Senator DURBIN. Chairman Gensler, as you look at the volume of work that you're faced with, the new responsibilities, what do you think is the—let me state it this way.

What would you recommend as the optimal number of people that you need in your agency to do that job effectively?

Mr. GENSLER. Under the current authorities, because, of course, we'll work together with Congress and with the rest of the administration on new authorities,—thank you, Senator Tester.

Under the current authorities, the agency put forward, as Senator Collins said, an appeal letter in February that was speaking to—I think it was about 650 full-time people under that \$177 million.

I don't know yet, again through just 6 days, whether that's going to allow us to fully cover, but I agree with Acting Chairman Dunn that it's more toward that number of people and it may be as high as some figures I've seen inside that are a little higher than that, closer to the 700-person figure.

ENFORCEMENT PENALTIES: AMOUNT, RECOVERY AND DETERRENCE

Senator DURBIN. When Chairman Schapiro was here, I noted that the fees collected by her agency within the marketplace generated about 40 percent more than the annual appropriation for her agency.

Similarly, in your situation, the penalties that have been assessed for wrong-doing and the amounts collected, I've seen varying estimates of this amount, but they appear to be over the last 8 years somewhere between \$1.5 and \$2 billion your annual appropriation, for last year \$146 million, in comparison there.

So could you say to me, I mean, or could we say to those who are observing this hearing that when your agency does its job and ends up with a trustworthy marketplace, it also is engaged in enforcement actions which bring in more revenue than the actual budget of the agency?

Mr. GENSLER. I think, Mr. Chairman, that the agency—we could say to those looking at this is a sound investment of a \$160 million for the next year of taxpayer money because in helping police these markets, enforcing these markets, bringing integrity to the markets, making sure that they're fairly priced in the marketplace is the crucial thing.

But in addition, you're right, there are enforcement actions that have penalties. The penalties are at least greater than the budget. The collections tend to be a little less than that, as you know.

Senator DURBIN. How well is the CFTC able to measure the deterrent impact of these enforcement actions?

Mr. GENSLER. It's a challenge to measure the results, but we believe that the stronger we are in enforcement, just as Chairman Schapiro said, in finding some of those cases that you can really

bring the wrong-doers to bear is critical to make sure that the markets operate better.

Senator DURBIN. What is your recovery rate?

Mr. GENSLER. As I understand it, the collections on the large manipulation cases are very high. The collection on the Ponzi schemes and fraud cases, unfortunately, is very low because so often those individuals behind those cases don't have any money, but I believe it's somewhere in the 30 to 40 percent when you average out high recoveries on complex manipulations and low recoveries on these Ponzi schemes.

Senator DURBIN. I'd like your thoughts, and maybe you can share them with me in separate communication, about whether the current penalty structure is in fact at a level consistent with creating a deterrent and what additional remedies or instruments you may need for that recovery rate to improve, and I understand that, as you said, some recovery is going to be extremely difficult.

But if you would take a step back and look at those two aspects, the deterrence and recovery, and give us your thoughts on that, I would appreciate that very much.

Mr. GENSLER. We will follow up with you, Mr. Chairman.

Senator DURBIN. Thank you.

Senator Collins.

DERIVATIVES REGULATION

Senator COLLINS. Thank you, Mr. Chairman.

Just two final questions from me. Senator Levin and I have introduced a bill that would repeal the language that prohibits the Commodity Futures Trading Commission from regulating derivatives, and I understand that the administration's new proposal would give both the SEC and the CFTC new authority to regulate derivatives.

What are your thoughts on this plan and the role of the CFTC in the regulation of derivatives?

Mr. GENSLER. I wish to applaud you and Senator Levin on that bill. I believe that we have to have, working with Congress, significant amendments to the Commodities and Exchange Act and seeking the same goal, to bring all the over-the-counter derivatives marketplace under regulation.

I think the Commodity Futures Trading Commission has the lead expertise on derivatives. Futures are a form of derivatives and these things that are now called over-the-counter swaps are another form of derivatives.

Working with Chair Schapiro, I'm hopeful that we can present a unified front and, as she said, you know, there's the boundary issues are important.

I think it's critical that we not have any gaps in regulation, but we believe at the CFTC and I believe interest rate swaps, currency swaps, commodity swaps, equity swaps, credit default swaps and any swaps invented in the future that are just a blip on the radar need to come under this regulatory regime.

There may be areas where a swap is more security-like, like a single issuer credit default swap, where, of course, we need multi-agency work, insider trading and SEC, you would want very much involved in things like that.

Senator COLLINS. Actually, I would argue that the credit default swaps were more like an insurance product and yet they were not regulated by State insurance agencies either.

Mr. GENSLER. They had many insurance attributes. There were many lessons, unfortunately, out of this crisis. You were earlier asking Chair Schapiro, but I think one of the great lessons of AIG was that there was unregulated institutions. That's why I am for regulating all derivative dealers, whether they're affiliated with banks or not.

But then these products, as you say, credit default swaps, have attributes of insurance, like monoline insurance. They have attributes of securities.

Senator COLLINS. Exactly.

Mr. GENSLER. They have attributes of derivatives that the CFTC is the expert on.

Senator COLLINS. Which is why we need this council of regulators approach because the problem now is the marketplace is always going to be innovating and we want it to be innovative and producing new kinds of products and we need a system where just because a product is new does not mean that it falls into a regulatory black hole and no regulator ends up having responsibility and no regulator or regulators is looking at the impact across the financial system.

When you think of a credit default swaps situation, here we have a new product that grows into the trillions of dollars, jeopardizes the entire financial market, and yet it doesn't fall under securities, it doesn't fall under insurance, it doesn't fall under the Consumer Product Safety—I mean the Commodity Futures Trading Commission. So clearly, we need to resolve that.

Let me just turn to another loophole that our hearings took a look at and that's the so-called swaps loophole that allows financial institutions to evade position limits on commodity contracts that regulators are using to prevent unwarranted price swings or attempts at manipulation.

What should be done to close that loophole?

Mr. GENSLER. I think that explicit authority should be given to the Federal regulators, with the CFTC taking the lead on position limits, to bring the over-the-counter derivatives marketplace under a regulatory regime: that we regulate all of the dealers to make sure that they are not manipulating, that we're policing fraud, that we're policing position limits, aggregate position limits, as I referred to earlier, that we, amongst the regulators, have an enormous opportunity to see 100 percent of the transactions.

INTERNATIONAL

Senator COLLINS. Finally, do you have sufficient funds to pursue your international responsibilities?

What I'm thinking of is there is a problem with foreign exchanges and what rules they're going to play by, particularly if they're dealing with U.S. commodities which they are, and particularly when they have a presence in the United States.

I don't know whether that's an issue you've looked at yet, but the SEC seems to be far more active in that area than the CFTC is.

Mr. GENSLER. Well, Senator, you're right that we've had to make as an agency tough trade-offs, an agency that shrunk 20 percent in the last years, but thankfully with this year we'll start to move back.

There's a small Office of International Effort but it's very small, I think four or five people at the CFTC. We do share your concern and share the view that we have to make sure that foreign boards of trades that are influencing these markets and are in our markets have consistent regulation, come under the position limits and other authorities here.

Though the CFTC has moved forward in this regard, we do think that it's important to work with Congress to embed in statutes some additional authorities with regard to foreign boards of trade.

Senator COLLINS. Thank you. Thank you, Mr. Chairman.

Senator DURBIN. Thank you, Senator Collins.

ADDITIONAL COMMITTEE QUESTIONS

Chairman Gensler, thanks for your testimony. We're going to keep the hearing record open until next Wednesday, June 10, at 12 noon for subcommittee members to submit statements and/or questions, and we ask that the information we requested you do your best to comply with at a convenient time.

[The following questions were not asked at the hearing, but were submitted to the Commission for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

MOST SERIOUS MANAGEMENT CHALLENGES IDENTIFIED BY INSPECTOR GENERAL

Question. The Reports Consolidation Act of 2000 requires the Inspector General to summarize the "most serious" management and performance challenges facing the Commodity Futures Trading Commission (CFTC). In the Inspector General's assessment report of November 14, 2008, the Inspector General identified two management challenges for fiscal year 2009.

The first concern is with the Modernization of Electronic Market Surveillance. The Inspector General explains that while market surveillance has always been an integral part of CFTC operations, the past years have witnessed the transformation of futures trading from an open outcry trading floor based system to an electronic system. In fact, in 2008, electronic trading accounted for 84 percent of total exchange traded derivatives.

The second area is the Efficient Acquisition and Integration of Skilled Human Capital. The Inspector General cites the fact that recent economic turbulence has simulated an interest in applying the historically successful centralized clearing mechanism to the bilateral and complex swap markets. The Inspector General expressed skepticism that the CFTC currently has the human capital to monitor these complex markets and that situation may demand review of existing hiring procedures.

Chairman Gensler, have you had an opportunity to review the Inspector General's analysis?

What is your reaction?

What is your plan for prioritizing these two key items in your management agenda?

Answer. Yes, certainly the need to modernize electronic market surveillance will require additional technological capabilities. It is also apparent that if the Congress entrusts the Commission with significant additional responsibilities, the Commission will need to expand its staff and pay particular attention to needed skill sets. The Congress provided the Commission with substantial additional funds for fiscal year 2009. At this point we have almost completed hiring the new staff funded for this year. I asked the staff to provide the following information on the modernization of electronic market surveillance:

In late 2008, the CFTC contracted with the Promontory Group to review the market surveillance program. Commission staff is finalizing its assessment of the Promontory report and preparing recommendations for the Commission. The objective is to ensure that the CFTC has an effective approach to surveillance, from both a programmatic and operational perspective.

The CFTC also is in the process of modernizing its trade surveillance system in order to perform its statutorily mandated oversight functions and to keep pace with the explosive growth in electronic trading. In 2007, the CFTC's Division of Market Oversight ("DMO") and Office of Information and Technology Services ("OITS") embarked on a multi-year plan to develop a new trade surveillance system ("TSS"), to replace the Commission's antiquated system. TSS is designed as a database of exchange data maintained by the Commission which can be evaluated with off-the-shelf alert and analysis tools. A contract was awarded to Actimize in 2008 to deliver such a product. OITS expects to have all of the exchanges connected to the Actimize tool by the end of the first quarter 2010.

A challenge to the Commission in implementing TSS has been a lack of data uniformity. To resolve this problem, in May 2007, DMO formed a subcommittee through the Joint Compliance Committee to discuss and formulate a plan for using "FIXML" as a standardized format for trade data submitted to the Commission and to formulate a FIXML transition plan. In December of 2008, a schedule was presented to all exchanges for submission of trade data in FIXML by the end of 2009.

The Commission has also been working to better link its trade surveillance and market surveillance systems. Currently, the Commission is unable to connect accounts identified by large traders with their intra-day transactions. To resolve this problem, the Commission has issued an advanced notice of proposed rulemaking to solicit comments on the collection of account ownership and control information from exchanges. Such information would be used to improve DMO surveillance by serving as an adjunct to the CFTC's ISS (large trader position data) and TSS databases.

ADEQUACY OF FUNDING TO PERMIT PAY PARITY

Question. In response to the 1980s banking crisis, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) (Public Law 101-73) which provided for pay parity among federal financial regulatory agencies.

The Commodity Futures Trading Commission was granted comparable pay authority (Public Law 107-171) with other financial agencies to level the playing field with a goal of attracting the best and brightest talent. Despite the authorization, the CFTC has not been fully funded to the level of comparable agencies covered under the law.

During recent years, the Commodity Futures Trading Commission's budget situation has resulted in hiring freezes and has not permitted a meaningful review by the IG to determine its effect on employee retention and whether new hires are appreciably more experienced or better qualified.

Chairman Gensler, what has been the practical impact of the CFTC's not having sufficient annual budget authority to accomplish pay parity for your workforce?

Answer. The Commission is currently near pay parity with the other FIRREA agencies with regard to pay, having implemented merit pay and new pay ranges. There are several areas where we need to align the Commission with the FIRREA agencies; these include personnel benefits and possibly some job reclassification.

The implementation of pay parity without sufficient budget authority has had the same practical effect as meeting all other resources challenges without sufficient budget authority—the Commission froze and/or restricted hiring and deferred investment in Information Technology. These steps were taken after exhausting all other savings from administrative efficiencies.

Question. To what extent has the CFTC's inability to compensate staff at comparable levels led to departures of experienced personnel to positions in other Federal financial regulatory agencies?

Answer. Since the Commission is currently comparable with other FIRREA agencies with regard to pay, and nearly comparable with regard to benefits, the Commission is no longer losing, as it once did, a significant number of staff to other financial regulatory agencies as a result of inadequate compensation. However, those past losses tell us it is important that the Commission maintain comparability with these agencies.

Question. What funding level would permit the CFTC to move toward providing pay parity?

Answer. The fiscal year 2010 budget includes approximately \$1.4 million that would permit the Commission increased contribution to personnel benefits package thereby making it more comparable to FIRREA agencies. Funding would also permit

the Commission to reclassify selected positions if an ongoing review concludes that is appropriate to support parity and to improve recruitment and retention.

Question. As CFTC Chairman, what are your goals in this area?

Answer. As a new Chairman I look forward to reviewing the findings and recommendations of the Commission Pay Parity Governance Committee before advancing any new goals of my own. However, I am committed to ensuring that the Commission receives adequate funding to stay comparable with our fellow financial regulatory agencies.

Question. When does the CFTC plan to institute a student loan repayment program as a recruitment and retention tool?

Answer. Our goal is to implement a student loan repayment program by the end of the year.

Question. What resources would that require?

Answer. We have initially set aside \$200,000 for the implementation of this program.

DERIVATIVES MARKET REGULATORY REFORM

Question. Derivatives—contracts between two investors betting on whether a stock, bond, or other security will go up or down in value—has ballooned into the world's largest trading market, estimated to be in the tens of trillions of dollars. Much of the activity is not currently under a regulatory apparatus.

This market has also helped catalyze the current economic crisis. Losses on one type of derivative known as credit-default swaps helped topple American International Group (AIG), prompting a government bailout that has grown to \$180 billion.

On May 13, President Obama unveiled a plan to regulate the derivatives market. This proposal includes new rules to restrict banks, hedge funds, and other investors, and has four goals: (1) force the trade of most derivatives through a regulated clearinghouse and require traders to report activities and hold a minimal level of capital to cover losses; (2) improve oversight by ensuring clearinghouses and firms dealing in derivatives provide copious information to regulators about their trades; (3) empower regulators to force traders to submit detailed information and pursue cases of fraud and manipulation; and (4) prevent derivatives from being marketed to groups that may not understand their complexities.

How would expanded derivatives regulation impact the CFTC workload? What budgetary considerations need to be considered?

Answer. We must establish a comprehensive regulatory regime to cover the entire over-the-counter derivatives marketplace. This will help the American public by: (1) lowering systemic risk; (2) providing transparency and efficiency in markets; (3) ensuring market integrity by preventing fraud, manipulation, and other abuses; and (4) protecting the retail public. I envision this will require two complementary regimes—one for regulation of the dealers and one for regulation of the market functions.

The Department of the Treasury, on behalf of the Administration, has submitted legislation to Congress to regulate the over-the-counter (OTC) markets. Although some improvements are appropriate to ensure that we best meet the goals stated above, the Administration's comprehensive proposal is consistent with regulatory reforms that the CFTC has proposed in testimony to Congress. The Administration's proposal will lower risk by requiring capital and margin on dealers and mandatory clearing of all standardized products. It will enhance market integrity by protecting against fraud, manipulation, and other abuses and establishing new authorities to set aggregate position limits. It will promote transparency and market efficiency by requiring recordkeeping and reporting for all derivatives and requiring that standardized derivatives be traded on transparent trading platforms.

Of course there would be a need for some additional resources at the CFTC to handle this expanded regulatory obligation. Until the nature and scope of the regulation of OTC derivatives markets is determined by the Congress, the resources necessary for implementation cannot be predicted with certainty.

Whatever the cost of regulation, it will pale in comparison to the cost of doing nothing. If the current financial crisis has taught us anything, it is that the derivatives trading activities of a single firm can threaten the entire financial system. The costs to the public from the failure of these firms has been staggering, \$180 billion of American taxpayer financial support for AIG alone. The AIG subsidiary that dealt in derivatives was not subject to any effective federal regulation.

MEMORANDUM OF UNDERSTANDING BETWEEN CFTC AND SEC

Question. Last year (March 11, 2008), then-Commodity Futures Trading Commission (CFTC) Acting Chairman Walter Lukken and then-Securities and Exchange Commission (SEC) Chairman Christopher Cox entered into a formal “Memorandum of Understanding” (MOU) setting forth several principles designed to guide inter-agency collaboration. The premise of this agreement was to seal some of the regulatory gaps and better accommodate new products that blur the lines between the futures and the securities worlds.

The MOU establishes a permanent regulatory liaison between the CFTC and SEC; requires quarterly joint meetings of staff; sets up a framework for extensive information sharing and exchange confirms existing enforcement policies; creates guidelines for new financial products that combine elements of securities, futures, or options; and addresses jurisdictional overlaps.

Chairman Gensler, can you describe some of the benefits to the CFTC since entering into the MOU with the SEC in March 2008?

Answer. The MOU has provided a formal mechanism to assure dialogue among senior staff of the two agencies regarding the treatment of novel derivative products and other issues of mutual regulatory interest. In addition, following on the MOU, the CFTC and SEC Divisions of Enforcement undertook efforts to improve coordination and cooperation. Specifically, in the summer of 2008, the CFTC and SEC Divisions of Enforcement appointed senior staff to serve as liaisons for their respective agencies, and also established quarterly meetings to discuss issues related to investigation and litigation dockets for matters of common concern. The enhanced cooperation between the CFTC and SEC Divisions of Enforcement is also reflected in the May 2009 joint training session for enforcement staff in which experts from both agencies discussed strategies regarding the agencies’ coordination, investigation and prosecution of several recent Ponzi fraud matters.

Question. What impediments hinder CFTC’s ability to oversee and regulate new products that have mixed characteristics of futures and securities?

Answer. Neither the CFTC nor the SEC currently has regulatory jurisdiction with respect to OTC derivatives transactions, some of which are relevant to both the futures and the securities markets. In areas where jurisdiction does exist, further enhanced communication between the CFTC and SEC staff—specifically, ongoing communications regarding whether activity detected by one agency implicates the jurisdiction of the other agency—will improve the CFTC’s ability to oversee and regulate such new products.

Question. How do intend to collaborate with SEC Chairman Schapiro in advancing the goals of this MOU?

Answer. In addition to direct communications with Chairman Schapiro, as we have done in discussing regulatory reform with respect to OTC derivatives, I anticipate that Chairman Schapiro and I will actively direct and guide our respective staffs to fulfill the objectives of the MOU. We will work cooperatively and collaboratively to remove unnecessary duplication and other regulatory roadblocks to innovative market developments, while assuring that there are no regulatory gaps that endanger the public interest. The agencies’ focus on this goal is currently reflected in our joint harmonization project, including the unprecedented joint meetings recently held by our two Commissions.

Question. Do you envision the need for any modifications to the agreement to strengthen the current interagency relationship?

Answer. The MOU was intended to be a “living” document. Just as the agencies have entered into an Addendum to the MOU with respect to novel derivative products, additional Addenda may be considered as the agencies address new issues and harmonization on a going-forward basis.

ENFORCEMENT ACTIONS TO PRESERVE MARKET INTEGRITY AND PROTECT MARKET USERS

Question. Detecting and deterring against illegitimate market forces requires CFTC’s steady vigilance and swift response. Over the past 8 years, CFTC has assessed over \$2 billion in civil penalties against perpetrators of various fraud schemes. For instance:

- To address manipulation, attempted manipulation, and false reporting in the energy arena, the CFTC filed 43 enforcement actions against 73 entities or individuals in the December 2001 to September 2008 period resulting in \$445.5 million in assessed civil penalties.
- To address misconduct in connection with commodity pools and hedge funds by unscrupulous and unregistered operators and advisors, from October 2000 and September 2008, the CFTC filed 73 enforcement actions against 24 entities, with \$564.13 million in penalties assessed.

—To combat the problem of foreign currency (forex) fraud, between December 2000 and September 2008, on behalf of nearly 26,000 affected customers, the CFTC has filed 98 enforcement actions, charging 374 entities or persons, culminating in over \$562 million in civil monetary penalties and \$454 million in restitution.

How well is the CFTC able to measure the deterrent effect of these enforcement actions?

Answer. Measuring the deterrence effect of enforcement actions remains a challenge to the CFTC and other law enforcement agencies. The CFTC has undertaken a number of actions to increase deterrence as noted below by staff:

—The CFTC maximizes the deterrent effect of its enforcement program through: the filing of enforcement actions, cooperative enforcement, public outreach and investor education. In cases of ongoing fraud, the CFTC's objective is to bring its enforcement action as quickly as practicable in order to stop the fraud, freeze assets, and preserve books and records. The CFTC also leverages the impact of its enforcement actions by working cooperatively with federal and state criminal and civil authorities who often bring their own actions based upon the conduct that violates the Commodity Exchange Act and CFTC Regulations. Whenever the CFTC files an enforcement action and obtains a final judgment in one of its enforcement actions, it publicizes these events through press releases and media interviews. To alert market users and the public to the dangers of fraud, the CFTC has issued a number of Consumer Advisories warning the investing public of potential risks and scams, and has posted these Advisories on its website. The CFTC also seeks to maximize the deterrent effect of its enforcement program by tracking industry trends. For example, the CFTC's Acting Director of Enforcement gave Congressional testimony in June 2009 regarding the observed uptick in fraud involving solicitation of retail customers for purported off-exchange transactions in precious metals, and certain energy and agricultural products. The fraudsters appear to have drafted customer agreements to make them appear to be spot contracts outside of CFTC jurisdiction and not futures contracts covered by the Commodity Exchange Act.

—The CFTC remains committed to developing improved performance measures to reflect the deterrence effect of its enforcement program. For example, the CFTC has requested funds every year since the fiscal year 2007 OMB budget request thru fiscal year 2010, to study the performance measurement issue, however, funds, to date, have not been approved.

Question. How rapidly are you able to collect restitution, disgorgement of ill-gotten gains, and civil monetary penalties imposed against violations of the federal commodities laws?

Answer. When the CFTC files enforcement actions that include allegations of fraud, its general practice is to seek a statutory restraining order to immediately freeze the defendants' known assets, including trading and bank accounts, homes and other real property and cars. These assets are then preserved for purposes of customer restitution or disgorgement at the conclusion of a successful prosecution. The CFTC Division of Enforcement may also request that the federal district court order defendants to make an accounting, which assists the CFTC in tracking money flows and identifying additional assets for recovery. The CFTC also names as relief defendants in its enforcement actions persons known to have received funds derived from the fraud and to which they have no legitimate claim, and seeks to freeze and recover these funds for return to customers as well. At the conclusion of litigation, and in the event of a remaining judgment, the Commission follows an established protocol to ensure that matters are appropriately referred to the Department of Justice and Department of the Treasury for collection.

Question. What is the annual recovery rate?

Answer. Staff has supplied the following information:

Below is a table that sets out the CFTC's annual recovery rate for civil monetary penalties assessed for fiscal years 1992 through 2008.

CIVIL MONETARY PENALTIES ¹
[Fiscal year 1992-fiscal year 2008]

Fiscal year	Penalties imposed	Penalties collected
1992	\$3,207,277	\$2,285,664
1993	3,313,100	3,514,715
1994	4,112,407	3,134,266
1995	11,201,100	9,430,239
1996	1,335,000	1,526,000

CIVIL MONETARY PENALTIES ¹—Continued

[Fiscal year 1992-fiscal year 2008]

Fiscal year	Penalties imposed	Penalties collected
1997	4,532,000	1,752,636
1998	132,623,756	125,803,781
1999	85,863,311	22,165,368
2000	179,811,562	3,299,362
2001	16,876,335	3,170,252
2002	9,942,382	5,922,387
2003	110,264,932	87,699,077
2004	302,049,939	122,468,925
2005	76,672,758	34,163,077
2006	192,921,794	12,364,509
2007	345,614,139	12,137,848
2008	234,835,121	140,745,252

¹The discrepancy between the amount of civil penalties imposed and the amount collected is accounted for by the following factors: (1) when courts order the defendants to both pay restitution to victims and a civil monetary penalty to the Government, established Commission policy directs available funds to satisfy restitution obligations first; (2) in fraud actions, it is not uncommon that the proceeds of the fraud have been dissipated and/or that the penalty far exceeds the defendants' represented financial ability to pay; (3) delinquencies assessed in default proceedings against respondents who are no longer in business and who cannot be located or are incarcerated; (4) penalties imposed in one year may not become due and payable until the next year; (5) a penalty may be stayed by appeal; (6) some penalties call for installment payments that may span more than 1 year; (7) penalties have been referred to the Attorney General for collection; and (8) collection may still be in process.

Question. What has been the impact of more sophisticated information technology to monitor and detect fraud more readily?

Answer. In the enforcement arena for fraud cases, information technology assists in asset tracing, account reconstruction, and electronic data recovery of financial records. Improvements in information technology have improved the CFTC's search capability for evidence of illegal activity involving Internet websites, instant messages, e-mail and audio.

In the regulatory arena, as discussed above, the CFTC is currently implementing its new trade practice surveillance system (TSS). TSS is designed as a database of exchange trade data maintained by the Commission upon which off-the-shelf alert and analysis tools can be connected. A contract was awarded to Actimize in 2008 to deliver an alert and analysis tool that has the capability to perform sophisticated pattern recognition and data mining to automate basic trade practice surveillance, and to detect novel and complex abusive practices. TSS also will fill a vacuum in inter-market surveillance which only the Commission can address, e.g., where NYMEX and NYSE Liffe both list metals contracts.

Question. Are there any statutory or administrative impediments that prevent the CFTC from doing more to combat fraud?

Answer. As noted above, the CFTC has observed an upswing in retail customer complaints regarding potential fraud involving off-exchange transactions in precious metals, energy products and agricultural commodities. It appears that fraudsters are drawing upon the adverse precedent of a line of cases under *CFTC v. Zelener*, 373 F.3d 861 (7th Cir. 2004), in which the Seventh Circuit held that certain contracts were spot transactions beyond the jurisdiction of the CFTC. Congress addressed this problem in the CFTC Reauthorization legislation included in the 2008 Farm Bill with respect to *Zelener*-type foreign currency transactions. A similar fix is needed if the CFTC is to effectively prosecute boiler rooms offering *Zelener*-type contracts in metal, energy, and other commodity contracts to retail customers (and is included in the Administration's proposed OTC derivatives reform legislation).

In addition, in the wake of the decision in *CFTC v. Wilshire*, 531 F.3d 1339 (11th Cir. 2008), defendants in fraud cases increasingly are asserting that federal courts lack authority under the Commodity Exchange Act to award restitution based on customer losses suffered as a result of the fraud. *Wilshire* held that the proper measure of restitution is the gain to the wrongdoer, rather than the losses suffered by customers. In cases where the fraudster retains only a small portion of the monies fraudulently induced from customers, this limit on restitution threatens the CFTC's ability to obtain make-whole relief for defrauded customers.

Staff advises that additional statutory measures that may increase the CFTC's ability to combat fraud include, among others, the following:

- Amendment of the Privacy Act to clarify that CFTC investigators may seek promotional material and verbal sales solicitations without identifying themselves as CFTC employees or providing personal information as to their true identity.

—In Section 4n of the Commodity Exchange Act, provide authority to require accountants to maintain records of audit activity concerning commodity pools that would be available for inspection by the CFTC.

—Clarify that the CFTC need not show criminal intent in actions based on conversion under Section 9(a)(1) of the Commodity Exchange Act.

Question. Is the current penalty structure designed to serve as an effective deterrent?

Answer. Yes. Commission staff supplies the following background:

—Section 6(e) of the Act, 7 U.S.C. § 13a-1(d), instructs the Commission to impose a civil monetary penalty that is appropriate to the gravity of the violation. Commission precedent has long recognized the importance of deterrence in preventing violations, most recently in *In re DiPlacido* [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶30,970 (CFTC Nov. 5, 2008) (“[g]iven the gravity of DiPlacido’s offenses and potential maximum fine, the focus of the Commission’s analysis shifts to assessing a specific penalty appropriate to the level of gravity and suitable to deter future violations”). Indeed, the Commission signaled the paramount role that deterrence plays when it emphasized that “[i]n imposing monetary sanctions, the primary focus of the Commission’s analysis has been deterrence.” *In re Murlas*, [1987–1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶24,440 at 35,929 (CFTC Apr. 24, 1989) (emphasis added).

—Also, in last year’s CFTC Reauthorization legislation, Congress increased the maximum civil monetary penalty for manipulation, attempted manipulation, and false reporting to \$1 million per violation. See Title XIII of the Food, Conservation and Energy Act of 2008, Pub. L. No. 110–246, 122 Stat. 1624 (June 18, 2008); 7 U.S.C. § 13(a).

Question. What additional remedies or authorities might be useful to boost your recovery rate?

Answer. Staff has advised that additional statutory measures that could potentially boost the CFTC’s recovery rate include, among others, the following:

—Similar to provision for non-payment of penalties imposed in CFTC administrative enforcement actions (see Section 6(e)(2) of the Commodity Exchange Act), provide that a defendant’s non-payment of civil monetary penalties imposed in enforcement actions in federal court shall result in the non-paying defendant automatically being prohibited from trading and automatically suspending any applicable registration until the defendant pays the full amount of the penalty, with interest to the date of the payment.

—Provide that collection of judgments and orders in fraud actions shall not be subject to State homestead exemptions or other State or local impediments to collection.

—Provide that disgorgement and restitution awarded in CFTC enforcement actions are non-dischargeable in bankruptcy.

—Add disgorgement as an available sanction in administrative enforcement proceedings.

PERFORMANCE GOALS/MEASURING OUTCOMES

Question. The Commodity Futures Trading Commission (CFTC)’s performance-based budget for fiscal year 2010 delineates four specific goals tied to the agency’s overall mission. For each of the goals, several outcomes are specified.

First Goal.—Of the \$160.6 million in appropriations requested for fiscal year 2010, the CFTC would designate \$48.2 million (or 30 percent of the total funding) and 185 FTE to meet the first goal—to ensure the economic vitality of commodity futures and options markets.

The outcomes to be achieved as a result of the investment made related to this goal are markets that accurately reflect the forces of supply and demand for the underlying commodity, are free of disruptive activity, and are effectively and efficiently monitored to ensure early warning of potential problems or issues.

How does (or will) the CFTC measure whether and how well these outcomes are achieved?

Answer. The Commission has developed nine performance measures intended to measure progress in achieving the stated outcome objective. The performance results along with an annual performance analysis and review are included in pages 46–55 of the Fiscal Year 2008 Performance and Accountability Report available on the CFTC website at: www.cftc.gov/aboutthecftc/cftcreports.

Question. How does the CFTC intend to meet a performance goal of “no price manipulations or other disruptive activities that would cause loss of confidence or negatively affect price discovery or risk shifting”?

Answer. This goal is fundamentally tied to the Commission's mission and is a priority of the Commission market surveillance and enforcement efforts as noted by staff below:

—Continuous monitoring of market activity is the principal way the Commission seeks to protect the economic function of the markets. Effective market surveillance requires sufficient staff with expertise in each of the diverse markets under the Commission's jurisdiction. The Commission takes preventive measures to ensure that market prices accurately reflect fundamental supply and demand conditions, including the routine daily monitoring of large trader positions, futures and cash prices, price relationships, and supply and demand factors in order to detect threats of price manipulation.

—As discussed above, the CFTC maximizes the deterrent effect of its enforcement program through: the filing of enforcement actions, cooperative enforcement, public outreach and investor education. The CFTC also leverages the deterrent impact of its enforcement actions by working cooperatively with other federal criminal authorities who often bring their own actions based upon the conduct that violates the Act and CFTC Regulations.

Question. When it comes to a performance goal of "improving effectiveness and efficiency of market surveillance" what indicators will be used to determine if you have indeed reached this goal and how well? What is the baseline from which progress is to be measured?

Answer. A strategic priority of the Commission is to enhance the Commission's technological capability, improve data standards, and enhance in-house human analytical and decisionmaking capability—each in order to recognize, understand and adapt to market changes early on. Indicators of success will be progress in achieving the following tasks: upgrading ISS to get more timely market position information and to integrate trading data with position data; developing capability to provide real-time margin and settlement information; promoting data standards throughout the industry; developing and implementing sophisticated trade surveillance systems; developing automated capability to analyze and integrate off-exchange data as it relates to surveillance and investigations; developing a recruitment plan to address required skills; identifying needed competencies and developing a training plan that empowers employees to react quickly in understanding and resolving regulatory matters. Each of these tasks represents a strategic need of the Commission that is not currently being met adequately.

Question. Second Goal.—Of the \$160.6 million in appropriations requested for fiscal year 2010, the CFTC would designate \$42.9 million (or 27 percent of the total funding) and 160 FTE to meet the second goal—to protect market users and the public. The three outcomes to be achieved as a result of the investment made related to this goal are better detection and prevention of violations of commodities laws, high standards for professionals, and expeditious handling of customer complaints.

How does the CFTC plan to increase the probability of violators being detected and sanctioned?

Is this readily measurable?

What is the baseline against which future performance will be gauged?

Answer. Having sufficient resources to pursue violations is key to increasing the probability of violators being detected and sanctions. The Commission has developed four performance measures to assess progress in detecting violators. The performance results along with an annual performance analysis and review are included in pages 58–63 of the Fiscal Year 2008 Performance and Accountability Report available of the CFTC Web-site at: www.cftc.gov/aboutthecftc/cftereports.

Like all enforcement programs, we face a challenge in establishing overall performance measures that indicate the percentage of violative activity deterred, since no way has yet been devised to measure the total universe of violative activity that exists. The Commission keeps extensive records on the number of investigations opened and cases filed during the year, the number and amount of sanctions obtained, as well as the number of cases filed by criminal and civil law enforcement authorities that included cooperative assistance from the Commission. However, these statistics do not measure complexity of the matters opened and filed. For example, the Commission met its performance target in fiscal year 2008 with regard to the number of enforcement investigations opened. However, commencing in 2002, the complexity of Commission investigations has increased substantially over prior years (including the Commission's investigation of alleged energy market manipulation). As a result of these investigations, the complexity of the Commission's cases filed and litigated also has increased substantially since 2002. The Commission's performance target tries to take into account both of these factors but they cannot be predicated with precision.

Question. How will the CFTC ensure there are “zero unregistered, untested, or unlicensed commodity professionals (unless they are exempt from registration)”?

Answer. There are several complementary aspects to the Commission’s program that ensure compliance with registration requirements as summarized by staff below:

—*Registration and NFA Membership.*—Under Section 17 of the Commodity Exchange Act (“CEA”), the National Futures Association (“NFA”) performs registration functions on behalf of the CFTC. NFA registers members through its Online Registration System (“ORS”) a web-based registration and membership filing and processing system. With certain exceptions, all persons and organizations that intend to do business as futures professionals must register under the CEA. The primary purposes of registration are to screen an applicant’s fitness to engage in business as a futures professional and to identify those individuals and organizations whose activities are subject to federal regulation.

In addition, all individuals and firms that wish to conduct futures-related business with the public must apply for NFA membership or associate status. Mandatory membership serves an important function: NFA Bylaw 1101 prohibits members from conducting customer business with non-NFA members.

—*Testing.*—Individuals who are applying for NFA membership as a sole proprietor FCM, IB, CPO, CTA or for registration as an AP of any of these categories must satisfy proficiency requirements. Applicants generally must have passed the National Commodity Futures Examination (NCFE or Series 3) within the 2 years preceding their application.

—*Ethics Training.*—The CFTC Statement of Acceptable Practices (see Appendix B to Part 3 of the Commission’s regulations) for ethics training allows flexibility, permitting firms to tailor their training programs to best suit their particular operations. In an Interpretive Notice to its Compliance Rule 2–9, NFA states that good business practice dictates that employees receive periodic training to keep them cognizant of new developments in technology, commercial practices and regulations, and their ethical implications.

—*Oversight.*—NFA conducts ongoing audits of its registrants for compliance with NFA rules. In turn, Commission staff pursues formal and ongoing oversight of NFA’s compliance and registration programs. Formal oversight activities involve periodic reviews of NFA programs and inspection of records and interviews with NFA staff.

NFA pursues statutory disqualification and other disciplinary matters through Registration, Compliance & Legal Committee (“RCLC”) cases. On a quarterly basis, Commission staff meets with NFA to provide guidance on registration issues generally, and to review the past quarter’s RCLC cases.

These oversight activities are designed to protect market participants and the public interest by ensuring that persons who deal with customers and those who handle customer orders and funds meet the standards for fitness and integrity established under the Commodity Exchange Act.

Question. What type of tracking system is in place to demonstrate that this outcome has been achieved?

Answer. Currently, there are more than 67,000 individuals and companies registered with the CFTC in some capacity. Although it would be impossible to track the negative (i.e., that there are unregistered individuals conducting business), through its oversight of NFA’s registration program, the Commission ensures both that qualified applicants are properly registered, and that unqualified applicants (or registrants) are denied registration (or have their registration revoked). Through the quarterly meetings of the Registration Working Group involving CFTC and NFA staff, the Commission ensures that standards for such actions are applied consistently, and gives guidance when questions arise.

Question. With regard to meeting timeframes for resolution of customer complaints, how does the CFTC track disposition of complaints, proceedings, and appeals in order to show that the targets are achieved in the caseload?

Answer. The various Divisions at the CFTC (Enforcement, Clearing and Intermediary Oversight, Market Oversight, and General Counsel’s Office) each operate an “officer of the day program” to receive, and address or refer, inquiries (including complaints) from members of the public. The Office of Proceedings handles and tracks the disposition of adjudicatory matters at the hearing level. With respect to adjudicatory appeals to the Commission, pending cases are maintained with the Secretariat, with monthly status reports issued by the Office of General Counsel.

Question. Third Goal.—Of the \$160.6 million in appropriations requested for fiscal year 2010, the CFTC would designate \$38 million (or 24 percent of the total funding) and 144 FTE to meet the third goal—to ensure market integrity in order to foster open, competitive, and financially sound markets

The outcomes to be achieved as a result of the investment made related to this goal are that clearing organizations and firms holding customer funds have sound financial practices, commodity futures and options markets are effectively self-regulated, markets are free of trade practice abuses, and the regulatory environment is flexible and responsive to evolving market conditions.

How will the CFTC work to ensure zero loss of customer funds as a result of firms' failure to adhere to regulations and ensure that no customers are prevented from transferring funds from failing firms to sound firms?

What mechanisms does the CFTC have to monitor self-regulatory organizations to ensure that no funds are lost as a result of the failure of SRPs to comply with their rules?

Answer. Again, the Commission has several complementary programs that address the protection of customer funds held by FCMs) and derivatives clearing organizations ("DCOs"). They are summarized by staff below:

—*Protection of Customer Funds—Statute and Regulations.*—The Commodity Exchange Act and Commission regulations require each FCM to segregate from its own assets all money, securities or property deposited by customers to margin or secure futures and option on futures positions traded on designated contract markets or funds that accrue to customers from these open positions. Each FCM also must set aside in accounts (i.e., "secured accounts"), separate from its proprietary accounts, sufficient funds deposited by customers trading on non-United States futures markets to meet its obligations to customers trading on foreign markets.

—*Notification.*—Commission regulations also require each FCM to perform daily calculations demonstrating compliance with the segregation and secured amount requirements. Any FCM that does not maintain sufficient funds in segregated accounts or in secured accounts, as applicable, to meet its obligations to its customers (i.e., is "under segregated") is required to provide immediate telephone notice, confirmed immediately in writing, to the Commission and to the FCM's self-regulatory organization ("SRO") that conducts financial surveillance over the firm.

—*Commission and SRO Responsive Action (Direct Examinations).*—Upon receipt of a notice, Commission staff work with the applicable SRO to determine the facts and to assess whether the situation is a temporary under segregation that can be immediately rectified by the FCM infusing additional funds into segregated or secured accounts, or indicative of a more serious issue that may require prompt SRO or Commission action to protect customer funds. In certain situations, Commission and/or SRO staff may conduct an immediate onsite examination of the firm's books and records to assess the FCM's compliance with its financial requirements.

—*SRO Oversight.*—The Commission conducts periodic reviews of SROs' financial surveillance programs. The SROs' financial surveillance programs include routine examinations of FCMs to assess their compliance with Commission and SRO minimum financial requirements and related reporting requirements, including minimum capital requirements and compliance with the segregation and secured amount requirements. The Commission and SROs also may conduct an examination of an FCM on an exigent basis in response to an FCM filing a notice that it is not in compliance with the customer funds segregation or secured amount requirements. Experience has demonstrated that if the Commission and SROs can react promptly at the initial signs of weakness in the financial condition of an FCM, it is more certain that customer funds will be protected. In this regard, open futures and options on futures positions may be expeditiously transferred to another FCM if the FCM that is experiencing financial difficulties has properly segregated and secured customer funds.

—*Communication With SROs.*—Commission staff hold periodic meetings with the financial surveillance staff of the SROs for the purpose of discussing emerging issues and to coordinate examination procedures and policies. This includes an annual review of the detailed SRO audit programs, which are submitted to the Commission for review.

The resources requested by the Commission for the protection of customer funds would allow Commission staff to conduct more frequent assessment of the SROs' execution of their financial surveillance programs. Additional resources would also allow the Commission to conduct more frequent direct examinations of FCMs for compliance with financial and other requirements, including the segregation of customer funds.

—*Risk Surveillance Program.*—The Commission's risk surveillance and DCO review programs also serve to protect customer funds by (i) identifying traders that pose risks to firms and firms that pose risks to DCOs, and (ii) taking steps

to mitigate those risks thereby decreasing the likelihood of default. Additional resources would allow the Commission to enhance these programs.

Question. What are the advantages and disadvantages of “regulatory restructuring” from the perspective of the CFTC?

Answer. Exchange traded futures and options contracts are derivatives relied upon by the nation’s businesses for price discovery and risk management. The CFTC’s mission is to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options, and to foster open, competitive, and financially sound futures and option markets. Like exchange traded futures, OTC swaps and similar transactions are derivatives. Like futures, OTC derivatives are used for risk shifting purposes. In recent years the OTC market has grown to far exceed the exchange traded market in size. Bringing OTC dealers and markets under CFTC regulatory oversight will greatly enhance the ability of the Commission to fulfill its mission and to protect the price discovery and risk shifting functions of derivatives markets. Additionally, bringing the OTC dealers and markets under federal regulation will significantly improve financial integrity and transparency, qualities that were lacking in the collapse of firms like AIG and Lehman Brothers.

Question. Fourth Goal.—Of the \$160.6 million in appropriations requested for fiscal year 2010, the CFTC would designate \$31.5 million (or 19 percent of the total funding) and 121 FTE to meet the first goal—to facilitate agency performance through organizational and managerial excellence, efficient use of resources, and effective mission support.

Among the outcomes to be achieved as a result of the investment made related to this goal are a productive, technically competent, competitively compensated and diverse workforce, a modern and secure information system, and an organizational infrastructure that effectively and efficiently responds to and anticipates both the routine and emergency business needs of the agency.

How does the CFTC intend to measure progress and the extent to which these outcomes have been achieved?

Answer. The Commission has developed 18 performance measures intended to measure progress in achieving the stated outcome objective. Of the 18 measures 11 results were determined to be effective, one was determined to be moderately effective, and six were determined to be adequate. The performance results along with an annual performance analysis and review are included in pages 91–110 of the Fiscal Year 2008 Performance and Accountability Report available of the CFTC Website at: www.cftc.gov/aboutthecftc/cftcreports.

QUESTION SUBMITTED BY SENATOR SUSAN COLLINS

Question. Excessive speculation in the commodities market is prohibited under CFTC’s statutes. However, determining what constitutes excessive speculation is a thorny question. Last year, as oil and other commodities skyrocketed on the futures market, many in Congress became concerned that these market prices were more reflective of the activity of speculators than commercial interests in the underlying product. Last year, under the leadership of Chairman Lukken, the CFTC stated that despite the rapid increase in prices, the data did not reflect manipulation by speculators. Critics, however, contend that in this arena, the CFTC is simply outmatched. It lacks the manpower and resources to effectively collect the large volume of data in the commodities markets and to effectively analyze that data. Do you believe the CFTC needs more resources to gather relevant data and effectively analyze it to better understand the role and the effects of speculators?

Answer. The Commission examines markets by studying the behavior of commercial and non-commercial traders. In determining the status of traders, the Commission has traditionally accepted their self-classification. The Commission has begun to examine trader patterns to ascertain the general accuracy of these classifications. Commission assessments of the self-classifications are staff intensive and in order to accomplish them expeditiously and on a sustained basis, additional resources will be required.

On another front the Commission relies on market positions information that is updated daily. Without intraday position information, the Commission cannot examine any price effect occurring on the same day as a position change. This problem could be addressed were position information available throughout the trading day. Obtaining and processing such information will require additional resources for both staff and data processing capacity.

SUBCOMMITTEE RECESS

Senator DURBIN. Thank you very much for coming in.

Mr. GENSLER. Thank you, Mr. Chairman, Ranking Member Collins. Thank you so much.

Senator DURBIN. Thank you very much.

The subcommittee hearing is hereby recessed.

[Whereupon, at 12:27 p.m., Tuesday, June 2, the subcommittee was recessed, to reconvene subject to the call of the Chair.]