REVIEW OF INVESTOR PROTECTION AND MARKET OVERSIGHT WITH THE FIVE COMMISSIONERS OF THE SECURITIES AND EXCHANGE COMMISSION

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

JUNE 26, 2007

Printed for the use of the Committee on Financial Services

Serial No. 110–46

U.S. GOVERNMENT PRINTING OFFICE

37–560 PDF WASHINGTON : 2007

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

HOUSE COMMITTEE ON FINANCIAL SERVICES

BARNEY FRANK, Massachusetts, *Chairman*

PAUL E. KANJORSKI, Pennsylvania
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
JULIA CARSON, Indiana
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
DENNIS MOORE, Kansas
MICHAEL E. CAPUANO, Massachusetts
RUBÉN HINOJOSA, Texas
WM. LACY CLAY, Missouri
CAROLYN McCARTHY, New York
JOE BACA, California
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
MELISSA L. BEAN, Illinois
GWEN MOORE, Wisconsin,
LINCOLN DAVIS, Tennessee
ALBIO SIRES, New Jersey
PAUL W. HODES, New Hampshire
KEITH ELLISON, Minnesota
RON KLEIN, Florida
TIM MAHONEY, Florida
CHARLES WILSON, Ohio
ED PERLMUTTER, Colorado
CHRISTOPHER S. MURPHY, Connecticut
JOE DONNELLY, Indiana
ROBERT WEXLER, Florida
JIM MARSHALL, Georgia
DAN BOREN, Oklahoma

SPENCER BACHUS, Alabama
RICHARD H. BAKER, Louisiana
DEBORAH PRYCE, Ohio
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
RON PAUL, Texas
PAUL E. GILLMOR, Ohio
STEVEN C. LATOURETTE, Ohio
DONALD A. MANZULLO, Illinois
WALTER B. JONES, JR., North Carolina
JUDY BIGGERT, Illinois
CHRISTOPHER SHAYS, Connecticut
GARY G. MILLER, California
SHELLEY MOORE CAPITO, West Virginia
TOM FEENEY, Florida
JEB HENSARLING, Texas
SCOTT GARRETT, New Jersey
GINNY BROWN-WAITE, Florida
J. GRESHAM BARRETT, South Carolina
RICK RENZI, Arizona
JIM GERLACH, Pennsylvania
STEVAN PEARCE, New Mexico
RANDY NEUGEBAUER, Texas
TOM PRICE, Georgia
GEOFF DAVIS, Kentucky
PATRICK T. McHENRY, North Carolina
JOHN CAMPBELL, California
ADAM PUTNAM, Florida
MICHELE BACHMANN, Minnesota
PETER J. ROSKAM, Illinois
KENNY MARCHANT, Texas
THADDEUS G. McCOTTER, Michigan

JEANNE M. ROSLANOWICK, *Staff Director and Chief Counsel*

CONTENTS

	Page
Hearing held on:	
June 26, 2007	1
Appendix:	
June 26, 2007	67

WITNESSES

TUESDAY, JUNE 26, 2007

Cox, Hon. Christopher, Chairman, United States Securities and Exchange Commission	10

APPENDIX

Prepared statements:	
Bachus, Hon. Spencer	68
U.S. Securities and Exchange Commission	70

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

U.S. Securities and Exchange Commission:	
Written responses to questions from Chairman Frank	81
Written responses to questions from Hon. Paul E. Kanjorski	91
Written responses to questions from Hon. Al Green	101
Written responses to questions from Hon. Ed Royce	109
Written responses to questions from Hon. Walter Jones	111
Written responses to questions from Hon. Scott Garrett	114
Written responses to questions from Hon. Kenny Marchant	121
Joint response by Commissioners Roel C. Campos and Annette L. Nazareth to questions from Hon. Al Green	130

REVIEW OF INVESTOR PROTECTION AND MARKET OVERSIGHT WITH THE FIVE COMMISSIONERS OF THE SECURITIES AND EXCHANGE COMMISSION

Tuesday, June 26, 2007

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 2:04 p.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Present: Representatives Frank, Kanjorski, Maloney, Velazquez, Watt, Sherman, Meeks, Moore of Kansas, Capuano, Hinojosa, Clay, McCarthy, Baca, Miller of North Carolina, Scott, Green, Cleaver, Bean, Davis of Tennessee, Hodes, Klein, Mahoney, Perlmutter, Murphy; Bachus, Baker, Pryce, Castle, Royce, Biggert, Shays, Feeney, Hensarling, Garrett, Neugebauer, Price, Campbell, Bachmann, Roskam, and Marchant.

The CHAIRMAN. This hearing of the Committee on Financial Services will come to order. I am very pleased, along with the ranking member and the other members of the committee, to welcome all five Commissioners of the United States Securities and Exchange Commission.

For some reason, some people seem to think it was very unusual for us to listen to all five Commissioners. I want to say at the beginning, someone asked me why I was asking all five Commissioners to come now, rather than over the past 10 or 20 years, and the answer is very simple: I wasn't the chairman over the past 10 or 20 years.

I say that because the fact that we have asked all five Commissioners to appear before us is not a sign that there is great turmoil or trouble or anger. There are five Commissioners. They are all presidentially appointed and Senate confirmed. They all have decision-making power, and frankly I would have thought the relevant question would be how come you never talk to all five Commissioners, and this is a very important opportunity for us to do that.

But I really just want to dispel the notion that the fact that we have asked all five Commissioners means that somebody has a sense of impending doom. That is not the case.

We have a series of very important issues that are being dealt with by the Commission. And let me say first, on the subject of it being all five Commissioners, one or two of the issues we will get into today we will be asking—I will be asking what the progress

is. And I understand that trying to get a consensus among the Commission is a factor. That's a legitimate one.

The SEC is, to a very great extent, a law enforcement agency. And no law enforcement in a free society will succeed if there is not a significant degree of acceptance of the fairness of the rules by those against whom they are being enforced. We are not ever going to create in this country a core of enforcers sufficient to watch everybody all the time: We don't want it; we can't afford it; and it would not be the society we want to live in.

That means, as I said, there has to be some degree of a buy-in by those who have to abide by the rules. Three to two votes of a Commission enforcing rules undercuts our ability to do that over time. If you think a rule is a bad idea and it is voted by all five members of the Commission, it seems to me you are likelier to acclimate yourself to that than if it's three to two and you just wait for somebody to die, get appointed to something else, or get bored and go off and do something else.

So I want to acknowledge that it is a relevant factor to try to get the kind of vote that will help us have these things enforced. On the other hand you do come to a point where decisions have to be made, and I guess I would say if there were never any three-two decisions, I would think that there was a problem, and that we were shying away from dealing with some tough issues, but if there were a lot of three-two decisions, that would not be a good sign either.

And in my judgment, the Commission, as currently constituted, has hit the right kind of balance. I do think that we need to press forward in a couple of areas, but I do understand, as I said, the importance of the consensus.

Secondly, I want to begin by talking about a couple of things for which I think the Commission deserves a great deal of credit and for which it has not gotten enough credit, not surprising in today's world. First is the revisions that you have put forward, along with the PCAOB in Sarbanes-Oxley.

Now I can speak about Sarbanes-Oxley without any kind of pride of authorship or defensiveness. While I was on the committee when it was adopted, I was not the ranking member. It was not one of the things in which I was very active. I think it was a very important piece of legislation, and I think it has done a great deal of good.

There is a problem in our society and in our controversies in which when we do something good, we tend to pocket the benefit, ignore it, and then focus on those things with which people aren't fully satisfied. I think anyone who compares what's gone on in the markets, the attitude towards investing today, compared to what we had during the height of the Enron and MCI situations, will understand the importance of Sarbanes-Oxley.

I was pleased recently to get a letter from the Chamber of Commerce saying that the quality and performance of boards of directors has significantly improved in substantial part because of Sarbanes-Oxley. Now they sent that letter in the context of telling me we didn't have to do anything about executive compensation, but the fact is that they still gave full credit to Sarbanes-Oxley.

There was one area where I think there was a consensus, that we needed to make some changes. In implementing section 404 it does appear that we went a little too far, those who did it. That's not surprising; this is a new enterprise and people don't always get things perfectly the first time.

I believe that the Commission along with the PCAOB in a collaborative fashion has responded appropriately and I am struck by a number of people who still ask me, well, when are you going to make these changes in Sarbanes-Oxley when in fact they are well underway.

Now there may be some who would like to go further. I do note that Secretary Paulson, when he testified before us last week, disagreed with the notion that legislative change was necessary. Secretary Paulson strongly asserted his view that he thought that what the Commission was doing now was appropriate and in fact responded to the need, and I'd be interested in the Commission's view.

Secondly, and the Commission's statement does refer to one of the great issues we will be dealing with soon, which is the question of harmonization, cooperation, internationally—we have had, for all of our time, securities regulation that was nationally based. Increasingly we have securities transactions that are not nationally based, that are transnational and trying to make that work is important.

The policy that the Commission has embarked on, mutual recognition, for instance, in the accounting area, I think is a very appropriate response. And it does look to me like we're making real progress there. The concept of mutual recognition obviously has application elsewhere, so those are two areas where I am very supportive of what the Commission is doing.

There were a couple of other areas I will get to in my questions. I'm just going to touch on them now so I can get to the other statements. One is, that I have had increasing concerns expressed to me about the problem of naked short selling. And some of our former colleagues who have been engaged in this work have talked to me about it, and it does appear to me to violate some fundamental rules. I have spoken to the Chairman about it and I hope that we can get some conversation about that.

And the other area, the one area where I would hope we would pretty soon be able to get some resolution, is the question of proxy access. It does seem to me that this is an area where there's a lot to be said for getting a decision. Obviously I hope it is a decision that will improve proxy access. I continue to be bemused by the fear of shareholders that exists among some in the corporate world.

I don't know what phobia that will be. I guess we should have a contest: what phobia is it when you are afraid of your own shareholders? But it does seem to me that fear is excessive, and I hope we can touch on that.

With that, I will recognize the gentleman from Alabama.

Mr. BACHUS. I thank the chairman. And Chairman Cox and the Commission, I want to welcome you on behalf of the minority on the committee. I think you've done an excellent job. I think the Commission has worked well together.

The subcommittee ranking member Ms. Pryce and I are going to yield our time to six members for opening statements, but please know that she and I both think you've done an outstanding job and we compliment you.

At this time, I will yield 2 minutes to the gentleman from Louisiana.

Mr. BAKER. I thank the ranking member for yielding time. I think it's important in this brief period to recognize the problem currently engaged in our U.S. securities markets, which is an overriding prevalence of securities class action litigation. The result is that Fortune 500 companies in this country pay 6 times as much in insurance as they do in Europe.

But the cost is not just to companies; it is to investors as well. Typical settlements to avert expensive litigation result in awards averaging from 2.3 to 2.9 percent per loss claimant, rarely giving defrauded investors any real financial return. And it is the smallest investor which is most disproportionately adversely impacted, having the most limited resources to pursue relief and also having the least diversification in portfolio, resulting in concentration of loss risk.

The 2007 Bloomberg/Schumer report states the prevalence of meritless securities lawsuits and settlements in the United States has driven up the apparent and actual costs of business and driven away potential investors. The Chairman of the President's council of economic advisors states that the size and frequency of damage settlements and securities class action suits sets the United States apart from other major financial centers and is an important factor in the declining competitive position of our markets.

So in an arena where it is clear that relief is obvious and necessary to stem frivolous suits in a period when global markets are gathering momentum, the announced plan to pursue recovery is the now new scheme liability approach. This seems incredibly out of touch with market function and necessity. This clear and present danger, the current proposed remedy, flies under the flag of this creative scheme liability assignment. This would extend the actionable causes for plantiffs' financial claims to parties which did not make fraudulent representation to the defrauded investors.

The facts of the Stoneridge case would, based on precedent of all other Federal appeals holdings, be set aside without merit. So it should be, save for a single appellate court holding. Dramatic expansion of causes of action will have an untenable market consequence which will expand beyond all reason filings without merit already facing significant adverse market conditions, would make our markets clearly less competitive and deter outside investment in the United States, and result without doubt in a debilitated U.S. marketplace.

I cannot conceive in a world where anyone who has a claim ready to be filed there is more than one firm ready to fabricate the cause of action, go to court and for a limited fee pursue those with deep pockets for whatever reason that might yield a claim through the class attorney.

It strikes me as odd that where our class action system results in an average payment of pennies on the dollar to the claimant and yet the trial bar is making a very substantial income we continue

to focus on expanding the reasons and opportunities for people to file such frivolous suit.

I yield back.

The CHAIRMAN. The gentleman from Pennsylvania, the chairman of the Subcommittee on Capital Markets.

Mr. KANJORSKI. Thank you, Mr. Chairman. I just wanted to congratulate you for assembling this tremendous panel that we are going to get an opportunity to hear from. So with no further ado, and intending to listen to the panel, I thank you for the calling of this hearing.

The CHAIRMAN. The gentleman from Delaware is recognized for 2 minutes.

Mr. CASTLE. Thank you, Chairman Frank, and Ranking Member Bachus, for holding this hearing before the Financial Services Committee today, and I thank all of the Commissioners for being here today.

I look forward to hearing from each of you regarding the Commission's investor protection initiatives and efforts to maintain the virtue of our markets. I commend the chairman and the Commissioners for their hard work over the years and realize that creating the rules and regulations that govern our Nation's securities industry is a difficult and enduring process.

With that being said, I have some ongoing concerns, particularly regarding pension fund investments in hedge funds, stock option manipulation, and 12b-1 fees, which I would encourage the Commission to examine.

The New York Federal Reserve president Timothy Geithner has repeatedly warned that hedge funds pose the largest risk since the long-term capital management crisis and Treasury officials have cautioned that a hedge fund collapse has the potential to affect the overall financial markets. While I understand that there are risks associated with investments, I want to make sure we are not ignoring these warnings and perhaps end up with an overreaction from Congress in the event of another LTCM.

Increased disclosure of the industry, which has grown more than 400 percent since 1999, is necessary and will further enhance market discipline and investor confidence. I also have concerns that certain manipulation of stock options may still persist, but I was pleased to hear that the Commission has made their investigations of backdating options a top priority.

I have been monitoring this issue, especially with regards to the timing of stock options grants to ensure the new disclosure rules are effectively detecting further manipulation. These practices are a violation of insider trading rules and place shareholders at a serious disadvantage.

Lastly, the 12b-1 rule, which was issued in the 1980's to assist struggling funds in getting their materials out to investors needs to be fully reformed. Funds are not struggling today with the same advertising dilemmas as they were in the 1980's and fees are now being used to compensate broker-dealers. The use of the 12b-1 fee is unclear to investors and if the intent of the fee has evolved from the 1980 intent of advertising a distribution to now compensate brokers it should be reevaluated and dealt with as such.

Reform of this rule is long overdue and I strongly encourage the Commission to make this fee more transparent so that investors are not being misled by certain mutual fund fees.

Mr. Chairman, I thank you for holding this hearing today, I look forward to hearing from the witnesses, and I yield back the balance of my time.

The CHAIRMAN. The gentleman from New Hampshire is recognized for 4 minutes.

Mr. HODES. Thank you, Chairman Frank, for holding this important hearing on the SEC's role in investor protection and market oversight, and I welcome the panel, including the Chairman and the distinguished Commissioners.

According to the SEC's Web site, the mission of the SEC is to protect investors, to maintain fair, orderly, and efficient markets, and to facilitate capital formation. I have a number of significant concerns about the structure of the recent initial public offering or IPO of the Blackstone Group LP. This offering is essentially not regulated by the SEC.

According to the Investment Company Act of 1940, in a recent court decision, I believe that it should be. Under the Investment Company Act of 1940, if more than 40 percent of a company's assets are "investment securities," the company must register as an investment company before offering shares to the general public.

When Blackstone was only dealing with millionaires who invest in hedge funds they weren't subject to SEC regulation, however, in my judgment, the day Blackstone issued an IPO and Main Street investors were able to purchase stock in their company they should have registered with the SEC under the 1940 Act like other public investment companies.

Once a company goes public it has a fiduciary duty to its investors. This is one of the largest IPOs in recent years and it is unacceptable to this Congressman that the process has not been more transparent for investors.

I believe the SEC has an obligation to ensure that the 1940 Act is not violated and that investors are protected. I am concerned that this offering sets a precedent for other hedge funds, private equity funds, to go public without complying with applicable law.

I look forward to hearing from the panel on compliance with the Investment Company Act, fiduciary duty, and national security implications, which I think are inherent in this IPO because China has bought a major stake in this company.

Thank you, and I yield back, Mr. Chairman.

The CHAIRMAN. The gentleman from California.

Mr. ROYCE. Chairman Frank, I thank you for holding this hearing. I thank you also for having all five SEC Commissioners here, and I just wanted to personally welcome my good friend and former colleague Chairman Cox, who represented a neighboring district in Orange County prior to his appointment as head of the Securities and Exchange Commission, and I believe, Mr. Chairman, who attended law school with you as well.

And there has been a lot of attention recently on flight of capital out of the United States into London, into Hong Kong, and into Dubai. And the fact that only 2 of the top 20 IPOs that went public in the United States last year—what's that, that's about 10 percent

compared to 12 of 20 in 2001—reflects an aversion of our public markets by corporations around the world. That's something we should address today.

The three major studies on U.S. competitiveness released in the last year focus attention on two great hindrances afflicting our public companies. The first is the regulatory environment within the United States, most notably, Sarbanes-Oxley, and the burdensome requirements it places on such companies. We had this remark from the former chairman of the Federal Reserve, Alan Greenspan. He said, "most of Sarbanes-Oxley is a cost creator with no benefit I'm aware of; regulatory and statutory changes need to be made as well if we're going to move forward; I hope it happens before the whole financial system walks off to London."

And then second, the bipartisan Bloomberg/Schumer Report says that the prevalence of meritless securities lawsuits and settlements in the United States has driven up the apparent and actual cost of business and driven away potential investors. So these studies show that when companies are allocating millions of dollars funding overly burdensome reporting requirements and protecting against frivolous lawsuits they respond by becoming more risk averse or by looking at alterative markets at home or abroad.

If we are to remain the market of choice for the world's public companies, we must implement legislative and regulatory changes to properly address the problems facing these companies as recommended by former chairman Alan Greenspan. I look forward to hearing from the Commission, from the SEC, on these and other important matters this afternoon.

Thank you again, Mr. Chairman.

The CHAIRMAN. The gentleman from Texas.

Mr. HENSARLING. Thank you, Mr. Chairman. I, too, want to add my voice to welcome our Commissioners, especially our former colleague Chairman Chris Cox. I do believe, although there are many important matters that will be discussed in today's hearing, clearly few will be as important as this expansion of a private right of action for secondary liability.

Many call it the great new consumer protection. I fear that nothing could be further from the truth. Recently there was an editorial in the Wall Street Journal, the June 9th edition, that I would like to quote from that I think encapsulates this challenge well: "What the SEC should be explaining is the damage that secondary liability will do to investors. Tort lawyers want to establish a breathtaking new legal standard, to wit, that any business partner or supplier," a bank, say, or a law firm, "of a corporate offender either should have known of the fraud or was reckless in not knowing and thus is guilty of aiding and abetting fraud. Under such a standard, this newspaper could be sued for running an advertisement in which a company misreports its earnings."

Companies should be held liable for the culpability of their actions not their proximity to a fraudster much less the size of their bank account, and I fear, unfortunately, this has less to do with consumer protection and more about expanding a target rich environment for the tort bar.

We've had many, many hearings about capital fleeing our country, avoiding our country, companies going private. And as we've

heard from the gentleman from Louisiana and the gentleman from California, much of it has to do with an environment in which we find many frivolous securities class action lawsuits.

And even when these lawsuits are justified, we have to remember that more often than not it's one set of innocent investors having to pay off another set of innocent investors. So we should look very, very carefully as we approach this area.

With that, I yield back the balance of my time.

The CHAIRMAN. Next, the gentleman from New Jersey, Mr. Garrett.

Mr. GARRETT. Thank you, Mr. Chairman. Thank you, Mr. Cox, and all the members of the Commission. Today's hearing is stated to be a review of investor protection and market oversight. I would like to just focus here on something that's equally as important as that, and that's America global economic competitiveness.

As Mr. Royce has already indicated, Secretary Paulson and others have testified about the two biggest problems that we're facing in our Nation's global competitiveness: excess litigation and regulation. But there are two recent decisions by this Commission that greatly concern me indicating that we're going in the wrong direction on both of these fronts.

Recently, there was a case of Stoneridge versus Scientific-Atlanta, where the Commission recommended that the solicitor general file a brief in support of the trial lawyers that would expand legal liability further and add to the heavy legal burden that's already being borne by our public companies.

A spokesman for the Department of Treasury noted in response that, "Treasury believes uncertainty related to primary liability for third parties could adversely affect the competitiveness of American financial markets by posing unknown risks for entities that do a broad range of business with public companies."

So if excess litigation is harmful, I don't see how expanding legal liability to third parties in instances like this will help to lessen that burden and encourage more listings on our markets.

The other decision by the Commission recently that has me concerned and troubled is the decision not to extend the exemption for small U.S. companies in complying with section 404; U.S. companies, small ones, will bear a disproportionately large share of the Sarbanes-Oxley burden.

This exemption, as you know, was extended last year through the end of 2007 so that the SEC and the PCOB could finalize their revised guidance to management and new standards by the auditors. And so while I commend the SEC for trying to improve these recommendations and implementations it remains unclear whether these revisions make it possible for small businesses to comply without still suffering severe economic consequences.

Furthermore, it is unfair I think to make our small businesses comply with these new regs that are just still now being finalized and adopted halfway through this year. So in light of that, 2 weeks ago I offered a bipartisan, small business SOX compliance extension act that would extend it for another year, the current exemption, and I would appreciate your comments on that in light of the fact that NASDAQ says as a percentage of revenue basis, it's 11 times greater for small businesses to have to comply.

And with that, Mr. Chairman, I yield back.

The CHAIRMAN. The gentleman from Georgia.

Mr. PRICE. Thank you, Mr. Chairman. I want to thank you and Ranking Member Bachus for having this hearing. I also want to thank Mr. Bachus for graciously yielding his time to allow these statements.

The two biggest problems facing our capital markets today are excessive securities litigation and overly burdensome regulation. Treasury Secretary Henry Paulson has called securities litigation the Achilles heel of our economy, threatening the ability of American financial markets to compete in today's increasingly international marketplace. In essence, we're trying to compete with one hand tied behind our back, while allowing our competitors to pass us by because of our failure to adapt.

We're all familiar with the Stoneridge case. Not only is it an over-the-top attempt by trial lawyers to extend the liability to third parties uninvolved in fraud but it should make shareholders and all Americans cringe due to the uncertainty and cost it would add to our system. Any verdict or settlement against a company ends up coming out of the pockets of shareholders and of the American people.

It's been said that Congress does two things well: overreact and nothing. And with the benefit of hindsight we can see that Congress dramatically overreacted with the Sarbanes-Oxley legislation. Our companies in our capital markets are now paying the price, which means that Americans are paying the price.

Since its passage, compliance costs for companies doing business in the United States have grown far beyond anything even the harshest critique anticipated. We must never limit our ability to detect corporate fraud and protect investors but congressional action is often a blunt instrument and the unintended consequences of this legislation have forced both corporate leaders and auditors to focus far too much of their time on compliance minutiae, diminishing the opportunities left for innovative strategies and growth due to their fear of facing harsh personal financial penalties. Reexamination dictates that reform is needed to ensure our capital markets remain competitive.

Let me briefly touch on one topic on which I intend to submit questions for the record. As exchanges have become for-profit entities, their for-profit status could create new conflicts of interest. I don't believe that the exchanges should have been prevented from seeking a change in their status or that fee increases are inherently inappropriate but the Commission must ensure its due diligence to ensure fairness in the process.

I thank Chairman Cox and the panel for coming and I look forward to the question and answer time. And I thank the chairman.

The CHAIRMAN. All requests and time having been accommodated, we will now begin the testimony, and as I understand it, we have a joint statement that was submitted by all five Commissioners which will go into the record.

My understanding is that the Chairman will be making an oral presentation, as well as a visual one. After that, we will go into the normal questioning, and questions may obviously be addressed to any of the five Commissioners.

I would urge members—we have obviously a lot of interest and it's a big committee—I will try not to cut people off, but I will advise members that the longer the preface, the shorter the answer is going to be that we can fit in, so members will be able to submit statements but I would urge members—let me just say at this point, in the interest of time, I'm taking on more time now, let me, on behalf of all the members, thank you all for coming.

[Laughter]

The CHAIRMAN. That may not sound like much, but if 37 people don't say, "I thank you very, very much for coming," we'll save a couple of minutes. So why don't you get right to your questions. They're nice people. They don't expect you to be excessively polite.

Mr. Cox, please go ahead.

STATEMENT OF CHRISTOPHER COX, CHAIRMAN, UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Mr. COX. Thank you, Mr. Chairman, Ranking Member Bachus, and members of the committee. I will say just once at the outset, thank you all very much for inviting us. We are all five of us very pleased to be here. As a former member of this committee, I have enormous respect for each of you and for the work that the committee does. We are all of us, all five Commissioners of the Securities and Exchange Commission, pleased to be here today to discuss the important work that the SEC is doing to protect investors, to strengthen our markets, and to promote capital formation.

The initiatives that we have underway at the Commission all have a common theme. They are aimed at benefiting investors who depend on healthy and well-functioning markets. This is the SEC's traditional responsibility. Back in Joseph Kennedy's day, our first Chairman, he was amazed that one in every ten Americans owned stocks. But today, over half of all American households own securities. In fact, when one considers the staggering growth in Americans' participation in markets, the enormity of the SEC's task today becomes apparent.

About 3,600 staff at the SEC are responsible for overseeing over 10,000 publicly traded companies; over 10,000 investment advisers who manage over $37 trillion in assets; nearly 1,000 fund complexes; 6,000 broker-dealers with 172,000 branches; and the $44 trillion worth of trading that's conducted each year on America's stock and options exchanges.

Perhaps the most striking development underway in our markets is that they are becoming increasingly interconnected with other markets around the world at an accelerating pace. This is challenging the United States and securities regulators around the world to collaborate more closely than ever before. Over the past year, a number of reports have been published which advised the SEC and the Congress on how to deal with our increasingly global capital markets. They've offered the Commission and policymakers in the Congress and the Executive Branch many recommendations, and undoubtedly more such recommendations are on the way.

While each of us may not agree with all of the recommendations and conclusions of these reports, we take seriously the detailed study that's gone into each of them, as we do the constant and var-

ied advice that's offered to the Commission from a host of financial services providers and consumers.

Mr. Chairman, many of the issues that we face are sometimes trivialized as disputes between business and investors. The truth is, only if the business succeeds will its investors prosper. That's why the SEC's first Chairman described the SEC's role and our relationship to business as a partnership. But anyone who seeks to drive a wedge between the interests of the business and the interest of investors in that business will find themselves confronted by a relentless and powerful adversary in the Securities and Exchange Commission.

Today, the SEC's Enforcement Division is substantially larger than it was 5 years ago. Our staff are engaged in combating a full range of abuses. We've created special working groups within our Enforcement Division to deal with emerging risks, such as hedge fund insider trading, stock options backdating, and micro cap fraud. Earlier this year, we filed the largest insider trading case against Wall Street professionals since the days of Ivan Boesky and Dennis Levine involving major Wall Street firms as well as hedge funds.

We've also devoted special attention to combating internet fraud, such as e-mails that tell investors, "This stock's Ready to Explode." And we'll have well over 100 investigations of backdating underway with the results of those cases coming forward very soon.

Seventeen years ago, in 1990, this Congress gave the SEC the power to levy penalties against individuals and against companies. But throughout the 1990's, that power was almost never used to sanction companies. It was only in 2002 that the Commission began to use its authority with any frequency. After extensive study within the Commission of the legislative language, the history, and the purpose of the Remedies Act, the Commissioners in early 2006 voted unanimously to publish a set of principals for a penalties policy and practice going forward.

Already this year, the Commission has imposed nearly as many penalties against companies as in any full year in the Commission's history. And the second highest SEC penalty ever imposed on a company, $400 million, came after the Commission unanimously approved its penalty guidelines. The Commission is continuing to work with our staff across the country to ensure, that as new cases are initiated and resolved, the guidelines are being implemented as intended.

To that end, the staff are beginning to present their recommendations for penalties to the Commission before negotiating penalties with the issuer. When we recover a penalty against an issuer or an individual, our efforts don't end at the courthouse door. We're increasingly using the new authority that you gave us in the Sarbanes-Oxley Act to use "fair funds" to ensure that those dollars are returned to investors as quickly as possible.

Since 2005, we have returned over $1 billion to injured investors through fair funds and will be announcing several additional large disbursements shortly. All of these enforcement initiatives undergird the integrity of the U.S. capital markets and the confidence that investors can place in them. Beyond the SEC's law enforce-

ment function, we are pursuing a number of important regulatory initiatives as well that are designed to put investors first.

With over 10,000 baby boomers each day turning 60, an estimated 75 million over the next 20 years, nowhere is there greater need for the SEC's attention than fighting fraud against senior citizens. Very soon, the vast majority of our Nation's net worth will be in the hands of our Nation's seniors. Following the Willie Sutton principle, scam artists will swarm like locusts over this increasingly vulnerable population because that's where the money is. We're attacking this problem from all angles, from aggressive enforcement efforts to targeted examinations and rules and investor education.

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

Yet another of our important initiatives to benefit individual investors is our drive to improve disclosure for mutual fund and 401(k) investors; 47 million Americans now have 401(k) accounts through their employers. Together with defined contribution plans, these accounts now represent over $3 trillion in assets. But the disclosure that the individual investor receives about what's in the 401(k) is typically inadequate. It offers nothing, in many cases, more than a one-page chart that contains extremely limited information. What's needed is clearly presented information that makes it far easier for busy Americans to understand the expenses that they're being charged in connection with their investments and the returns that they're actually getting. This sort of simplified disclosure should be readily available, and so we're hard at work on a simplified, plain English disclosure for mutual funds that gives investors what they need to know in a form they can use it.

We're also busy on our own regulations concerning mutual fund fees and expenses, and the disclosure of these costs to investors, including the $12 billion that investors pay each year in the form of 12b-1 fees. With the same objectives in mind, the SEC has intensified our focus on soft dollars, the moneys that brokers receive from mutual funds to pay for things other than executing brokerage transactions. Recently, the Commission acted unanimously to publish interpretive guidance that clarifies that money managers may only use soft dollars to pay for eligible brokerage and research services, and not for such extraneous expenses as office rent, carpeting, and even entertainment and travel expenses.

When it comes to giving ordinary investors the information that they need in a timely, useful way, nothing holds more promise than interactive data. It simply takes too much time and effort for investors to separately look up each SEC filing for every single company or fund that they own or might be interested in. Interactive data is changing that. It will allow any investor to quickly find, for ex-

ample, the mutual fund with the lowest expense ratio, or the companies within an industry that have the highest net income, or the overall trend in a particular company's earnings.

To ensure that shareholders have the opportunity to exploit this new informational power and SEC filings such as proxy statements, the Commission is updating our rules to permit the use of the Internet to improve communications between a company and its shareholders. For example, our recently adopted E-proxy rules will allow shareholders to choose whether to access their proxy materials in paper or electronically.

And, in connection with the Commission's review of our proxy rules governing shareholder proposals, we've just completed a series of roundtables that considered among other rules, the future role of technology in improving communications not only between shareholders and their company, but among shareholders themselves. As we prepare to put the new proxy rules in place in time for the next proxy season, to address the Court's decision in AFSCME against AIG, the Commission is also considering ways to make it easier for shareholders to interact online by removing any obstacles in the current rules. As a result of a Commission action just last week, interactive data will soon allow mutual fund owners to make instant comparisons of the "risk/return summary" provided by each fund and will soon showcase the potential of interactive data to help investors in yet another area, the disclosure of executive compensation under the Commission's new rules that have taken effect this year.

These new executive compensation disclosures represent a sea change. Instead of bits and pieces of information scattered about the proxy statement, buried in footnotes, or not properly disclosed at all, there is now one number that clearly totals all compensation from all sources. And that one number is clearly broken down into its parts, so that anyone who wants to compute the totals differently can do so. That's where interactive data comes in. Once all companies report their information this way using interactive data, it will be a cinch to reconfigure the numbers any way you please and to make instant comparisons across companies and across industries.

To demonstrate the power of interactive data to make the investor's job easier, the SEC will soon go live with a new tool on our Web site that will make the executive pay data interactive. Rather than tell you about it, let me offer you a brief example of how this will work. We can pull it up on the screen. Let me click into the first slide. This is what you will find on the SEC's Web site. It is our new Executive Compensation disclosure tool that will include data for the S&P 500. Here's how it works. Since we're here in the Financial Services Committee, we hit the "Industry" drop-down arrow. Let's look up banks and depositary institutions. Let's say you are focused on the largest bank. So you'd look up companies with the largest public float and the greatest revenue. And then we'll click "search" to bring up the companies that meet these criteria and scroll down to see the whole list.

Now we've gone from hundreds of companies to a manageable list of three banks. For the sake of protecting the innocent, this dem-

onstration uses notional data from fictitious banks, but rest assured that this works equally well with real ones.

The CHAIRMAN. As opposed to fictitious data from banks.

[Laughter]

Mr. COX. With interactive data, Mr. Chairman, you could do it both ways. So now, let's go to the CEOs who run these banks. Click on the scroll bar to see the whole table and using the "tools" on our site, we've now narrowed the field from more than 2,500 reporting executives to three CEOs at the three largest banks. Their summary compensation data is lined up next to each other for easy comparison. Before our new executive compensation rules and before interactive data, just coming up with this information would have required plowing through hundreds of documents, and it would have been a challenge for even the most proficient user of the SEC's EDGAR system.

But soon anyone is going to be able to find data like this in a matter of seconds. As you can see, the CEO compensation for the three banks that we chose ranges from about $26 million to about $39 million. But, using interactive data, we can generate much more useful information. For example, by clicking this button, "estimated potential value at grant date," you can see various executives' compensation using a different system to value their stock and their options.

The first table showed the value of total compensation using stock and option grants valued according to U.S. generally accepted accounting principles. In other words, it showed the expenses of the executives' compensation to the company. The second table shows compensation using an estimate of the potential value of the grants to the executives in the future. The range here, as you can see, is slightly larger than it was using GAAP, from about in this case $25 million to $41 million.

The beauty of interactive data is that investors can use whatever method they want. And, if you prefer, look at the "Graph" button. Scroll to see the full graph. Here's the "grant date fair value method." You can look at the data in graphical format using either method as well. Scroll over again, and use the "U.S. GAAP" button until you see that full table.

You may have noticed that the CEO of two of the fictional companies appear to make slightly more if you use the GAAP expense for stock compensation to the company. And the CEO of the third made slightly more if you use the potential value to him of stock options in grants. From the real world executive compensation data that we've tagged so far, we found that 62 percent of the CEOs at the 100 largest companies show equal or higher compensation using the generally accepted accounting principles method. And 38 percent showed higher compensation using the potential value method.

This tells us that, for those companies, more often than not, the one number that the SEC requires them to report for total compensation is showing a higher figure than if we use the full grant date, fair value method. But obviously the new rules require that all of this information be reported so investors can customize the figure any way they like. And that's what many people are already doing in a way that was never before possible.

It's important to recognize that interactive data is a truly international standard that revolutionizes the way that financial information is being exchanged across the planet. Technology is also driving the rapidly accelerating globalization of capital markets. We're confronting the challenges and opportunities of more foreign listings here in the United States in a number of ways, not least of which is the growing prevalence of international financial reporting standards.

The SEC now reviews IFRS financial statements from foreign issuers, right alongside U.S. GAAP financial statements from domestic issuers. And, just last week, the Commission proposed to eliminate the U.S. GAAP reconciliation report for foreign issuers.

Another matter of great importance in the international realm is rationalizing the implementation of the Sarbanes-Oxley Act. Because, while many countries, including the United Kingdom, have adopted requirements similar to our internal controls assessment in Section 404 of the Sarbanes-Oxley Act, ours is the only country that requires an independent auditor's report and attestation on those controls. And that fact has been a source of friction, not only with other markets, but also with other national regulators and international bodies.

The Congress has charged the SEC with making 404 work effectively and efficiently. And we're doing just that, recognizing that it will benefit not only U.S. investors, but also the competitiveness of U.S. companies and financial services providers throughout our global capital markets. The SEC has just finished over 2 years worth of work towards improving the implementation of 404 for all companies. Our new guidance will allow management to focus on what matters most, and a significantly improved 404 audit standard will enable auditors to deliver more cost effective services.

To ensure that we actually gain the efficiencies in 404 compliance that we intend, the PCAOB's inspection program will monitor whether audit firms and the SEC will monitor whether the PCAOBs are striving toward efficiency. No discussion of the work that the SEC is doing today would be complete without a reference to our role as the consolidated supervisor for the Nation's largest investment banks. In our role as the functional regulator of United States broker-dealers, we have long been concerned that a broker-dealer could fail due to the insolvency of its holding company or an affiliate. Our CSE program enables the Commission to monitor these major securities firms, which is of growing importance given their possible systemic implications.

Mr. Chairman, since we have the opportunity to appear before you today as a group, as a full Commission, let me offer a word in conclusion about the way we function as a body. This particular group of Commissioners has worked hard together to achieve our common goals of investor protection, efficient markets, and healthy capital formation. During my tenure as Chairman, 98 percent of the Commission's decisions have been the result of unanimous votes. That's not because the issues that we've just discussed are easy or because we always agree. Rather, it's because the capital markets of the United States and now the world depend upon clarity and consistency from the SEC. The Agency's non-partisanship has underscored that it's the rule of law and not one's political

point of view that should determine our actions. It's in this spirit that we continue to tackle the significant challenges that lie ahead.

So I thank you now as I did at the beginning for the opportunity to appear before this committee, and I look forward to working with you to meet the needs of America's investors. We look forward to taking your questions.

[The joint prepared statement of Chairman Cox and the other Commissioners can be found on page 70 of the appendix.]

The CHAIRMAN. Thank you, Mr. Cox. Some specific questions I'm going to be submitting—there is a great deal of concern about naked short-selling. I know this is something you've had under consideration. I'll ask it in writing. You give us a sense of where we are and there is a frustration on the part of some that in the face of Reg SHO and others the total seems to be going up, and this is the cause of some concern. So we would be interested in your view on that.

Secondly, I notice you say you are—did I read this correctly—you are close to a decision on proxy access?

Mr. COX. That is correct, Mr. Chairman.

The CHAIRMAN. What's the timetable?

Mr. COX. We intend to have proxy rules in place for the next proxy season, which will be late in the fall.

The CHAIRMAN. So you'll be promulgating that and it will be open for comment, I assume?

Mr. COX. Yes, the APA requires that.

The CHAIRMAN. Well, let me say this. Rather than take up your time now, this is an issue of great significance. Many of us are supportive of increased proxy access. There are some who would be concerned about it and that might well be something in which we might have a future hearing. So, I'm glad to know that by the Fall, we will be able to deal with this.

One other question from my Secretary of the Commonwealth of Massachusetts, Mr. Galpin, who is a very energetic securities regulator, because that's where the jurisdiction is up there. He's been concerned on the potential for pre-emption, and his question is whether there could be a pre-emption of State "blue sky" securities laws by Commission rulemaking. Is anything like that contemplated?

Mr. COX. When the question is put that broadly, I'm not sure, Mr. Chairman. Obviously, pursuant to statute, our rulemaking in many cases pre-empts blue sky regulations.

The CHAIRMAN. Right. Is there anything that's currently pending that you think might be?

Mr. COX. I don't know from the general way that the question was put what he might have in mind.

The CHAIRMAN. I guess the question is whether anything the Commission is currently considering might be preemptive of current State securities regulation.

Mr. COX. I don't believe so, and particularly with respect to proxy access, for example. We just had a series of roundtables focused on the pre-eminent role of State law in establishing shareholder rights and the importance of the Federal proxy regime in vindicating those rights. So we have, I think, a very healthy view among all five Commissioners.

The CHAIRMAN. Let me then turn to the—

Mr. COX. We have an amicable relation between Federal and State regulation associations.

The CHAIRMAN. Some of my colleagues expressed very critical views about Sarbanes-Oxley. I feel once again called in the spirit of bipartisanship to come to the defense of the Republican Congress and the Republican President who passed it—although there was a temporarily democratic effort. And I share the view of Secretary of the Treasury Paulson last week, that he thought that with the efforts that you and the PCAOB are undertaking, we are making the improvements that preserve the purposes of Sarbanes-Oxley without it being unduly burdensome.

Is it your view, and I would ask all five Commissioners, that any action is required by the Congress. Would you believe you now have the sufficient statutory authority among you, obviously to do what you're doing, but to do anything else. Do you feel the need for any congressional action to amend Sarbanes-Oxley?

Let me begin with Commissioner Nazareth.

Ms. NAZARETH. No. I don't. I believe that the steps that we took to address 404 were sufficient. That really was just about the only area of Sarbanes-Oxley for which we understood there were implementation difficulties. And I think that we had all the authority that we needed to address those issues and I believe that we have addressed them appropriately.

Mr. ATKINS. Well, as Commissioner Nazareth said, Section 404 was the problematic section. Right now, we have out for comment Audit Standard Five, which was passed by the PCAOB and sent over to us. Since it is now out for comment, I'm waiting anxiously to see what the comments will be, and I think after that we can then assess the situation.

The CHAIRMAN. Mr. Chairman?

Mr. COX. There is no question that Section 404 has been the flash point, the most expensive, compared to other sections, and particularly in relation to the benefits that it provides. So we have proceeded, all of us, on the premise that the cost benefit ratio has to be adjusted so investors actually get something.

The CHAIRMAN. And that was a five-to-nothing vote, I assume, to put that out for comment?

Mr. COX. It was indeed. It was indeed.

The CHAIRMAN. Commissioner Campos?

Mr. CAMPOS. I concur with the comments of my colleagues about 404. I believe that what we have done is essentially fix the problems with 404. We'll see. We'll look at the comments carefully. We'll see how it works. But I think, most importantly, Sarbanes-Oxley is a great asset for this particular economy, and I think that Congress needs to be very careful before any changes are looked at.

I work in the international arena and what I see is every jurisdiction copying Sarbanes-Oxley and looking in its own way to emulate what we have here in the United States. And I hear foreign investors tell me that they believe their capital is best protected in the United States by Sarbanes-Oxley and the protections that are offered here. So therefore Sarbanes-Oxley is not driving capital away. In fact, it is attracting capital. It is a magnet for capital.

The CHAIRMAN. Thank you. Commissioner Casey.

Ms. CASEY. I also agree with the comments of my colleagues about the fact that there's no need for legislation at this time. I believe that the changes that we've made in our management guidance and in the proposed auditing standard, which we do have out for comment and we'll closely look at the comments, encourage great cost savings and efficiencies and hopefully scalability for smaller companies.

But I would note that what will be crucial to whether or not we achieve them will be the implementation. And so I think that it will be very important as the Commission and the PCAOB look at the filing schedule for the larger filers whether or not we're achieving those savings, and then take a decision on whether or not we're getting the savings that we anticipated.

The CHAIRMAN. We've been trying to do that the way that would be sequenced.

Ms. CASEY. Absolutely, sir.

The CHAIRMAN. The gentleman from Alabama.

Mr. BACHUS. Thank you. I would ask Commissioner Casey if it feels different. A year ago, you were preparing tough questions for panelists.

Ms. CASEY. It's warmer down here, much warmer.

[Laughter]

Mr. BACHUS. My first question, after the slide show, I tried to prepare a quick question on "XYZ" corporation and the compensation of Richard Roe and John Doe, but I think I'll pass on that one. And my first question, Chairman Cox, I'm concerned over municipalities engaging in complex swap transactions without adequate technical expertise. Do you have concerns over the quality of disclosure and transparency when it comes to a municipal securities market?

Mr. COX. Yes, I do. It's an enormous market. It's in a market that is dominated by retail investors, traditionally thought to be safe, and yet we have seen significant examples to the contrary. Most recently, our enforcement division was involved in the City of San Diego because of securities fraud issues there. We have, on the other hand, only enforcement jurisdiction when it comes to municipal securities and limited to no jurisdiction with respect to preventing these problems before they happen.

Mr. BACHUS. Is there any practical reason why investors in municipal bonds should not be given or shouldn't receive the same information that investors in corporate debt receive? And would the markets benefit from more disclosures in this regard?

Mr. COX. I don't think there's any question that we can make significant improvements in the quality of disclosure. It's very complicated. You've heard me complain about the complexity of disclosure when it comes to corporate issuers. I think, if anything, it is even more complex, more prolix when it comes to municipal disclosure. It's not very user friendly, and there really doesn't seem to be much prospect for change on the horizon, absent some supervening force.

Mr. BACHUS. Thank you. Other Commissioners might want to add something. If not, I will move to my second question. My second question, for almost 30 years, we have had a regulatory system that divides financial products into securities and futures and regu-

lates them quite differently. No other country has the distinctions in how they regulate basically equivalent products. Should the United States have one agency to regulate both securities and futures and would you support modernizing the rule filing process so that the equities and the options markets could have self-executing rules similar to those that govern U.S. commodities and futures market filings?

Mr. COX. Well, you have asked me two very distinct questions.

Mr. BACHUS. Yes.

Mr. COX. Let me take them in order. With respect to the balkanization, if you will, of financial services regulation and the Federal Government, particularly as compared to other nations, I do not think there is any question that, as our markets continue to integrate globally, this is going to present increasing difficulties for us. On the other hand, we have historical reasons for the system that we have. And as a former of Member of Congress, I recognize fully how difficult it is to contend with those historical differences. But I think being respectful of that, speaking now only for myself, I can say that anything that the Congress can do to rationalize the regulation of products that increasingly are competing against one another or ought to compete against one another, that are similar in many respects but are regulated very differently, would be much better for the markets and investors.

Mr. BACHUS. All right, thank you. I guess I have time for one more question. In a speech last July regarding the Commission's soft dollar initiative, you stated that the initiative was designed to remove some of the uncertainties about how the 30-year-old law authorizing soft dollar arrangements applies in the current environment. What has happened in the year since you made that comment to warrant a call for the complete repeal of the safe harbor provision?

Mr. COX. What the Commission has done is work as well as we can within the statutory safe harbor for soft dollars. Section 28(e), because it is a statute, is something that the Commission cannot mess with. And so, to the extent that anything more is to be done to make it clearer to investors how these monies are spent, to permit competition and transparency, it will have to be done in the Congress. I should add that, to the extent that I, as Chairman, have expressed concerns and made recommendations about this, they are my own, and the Commission as a group is focused on rationalizing to the maximum extent that we can the statutory scheme that we are administering. So I think we have done a great deal. And to specifically answer your question, I think that life is better now. There is more clarity than there was before. We hope that our guidance is going to continue to have that effect, a salutary effect.

Mr. BACHUS. Do you believe there are any further steps, short of full repeal, that could be taken?

Mr. COX. There is no question. In fact, in the letter that I wrote to this committee, I counseled either repeal or revision, and I hope that you would at least consider all of those options.

The CHAIRMAN. The gentleman from Pennsylvania?

Mr. KANJORSKI. Thank you, Mr. Chairman. Mr. Chairman, I have eight questions that I would like submitted for the record,

and responded to in writing, rather than trying to read them and get some explanation today. One thing that conflicts me a little bit, Mr. Chairman, and members of the Commission, is in response to some of the questions today, particularly the chairman's questions, is there anything that the Congress can do to move you along and help you in your process? I think I heard that everybody is satisfied that you have all the jurisdiction in the world that you need on Sarbanes-Oxley. That being the case, I am constantly bombarded by studies indicating that we are not a very competitive society or financial market anymore. Furthermore, I constantly hear that 19 of the 20 largest IPOs were handled in Europe or elsewhere and not in New York. As a result, the skies over New York are falling. Does the Commission have an answer for this? Have you responded to some of these studies? Should we respond as the Congress and not expect you to respond? In reality, are these merely "the sky is falling" scenarios that should be ignored? Mr. Chairman?

Mr. COX. Well, I do not think, first of all, that the sky is falling. And, second, to the extent that anyone is telling us that the sky is falling, I think they are, at a minimum, overstating things. There have been a number of studies from a number of corners and sources that have counseled steps that Congress can take, the Executive Branch can take, and the SEC can take. Many of those studies have been very carefully considered, and I think they contain a number of useful facts and useful recommendations. So we are actually quite busy trying to do what we can as regulators to keep capital markets in the United States competitive. But, as I say, I do not think the sky is falling; I think rather what is happening is that all around us there is more competition. There is more opportunity to raise money and deeper, more varied pools of capital than ever before. And so, while the United States has the leading position in the world and the biggest markets and the deepest markets and the most liquid markets, that is not a birth right. We have to constantly earn it. That is true for our private sector, and it is true for our regulatory system. So we will work constantly to sharpen our competitive edge as regulators as well.

Mr. KANJORSKI. Comparatively, do you see any relationship between the number of IPOs that have been done over in London and the lack thereof in New York or is that situation just an anomaly?

Mr. COX. Well, there has been a great deal said and written about this. Those data have been taken apart and put back together front ways and sideways, and I do not know that I can add anything original to it today other than to point out that it is useful to look at each of the offerings to see where they came from, where their home markets are, what were the circumstances, and what would have been their prospects of listing in the United States. While we are surely feeling the effects of competition in this country, there is a steady stream of foreign companies that are continuing to tap the U.S. markets. This year, we are on pace to have the most foreign listings on U.S. exchanges since 1997 and, in fact, the second highest year in American history. Only that peak in the middle of the 1990's is yet to be surpassed. It was also recently reported that foreign companies accounted for 23 percent of IPO proceeds last year, the highest amount again since the mid-1990's.

Mr. KANJORSKI. So, the final conclusion I should come to is that there is no "sky is falling" scenario out there. In reality, we are very competitive, and Congress needs to do nothing to make the United States any more competitive?

Mr. COX. Well, just as I would observe that the sky is not falling, I would also observe that doing nothing is a very dangerous course. What we need to recognize is that it is a very dynamic, competitive world, that our capital markets are changing at an accelerating pace, and that we have to do a great deal if we are to maintain our traditional standards and are to maintain America's leadership for the benefit of our own investors. This is not just wanting America to be first; it is also a fact that we have the highest standards of regulation and investor protection in the world. And so, to the extent that more activity takes place on U.S. exchanges and in U.S. markets, investors are better protected.

Mr. KANJORSKI. Very good. I cannot quite get you to say, Mr. Chairman, that we are just the greatest and the best and the most competitive, but I will be satisfied.

Mr. COX. I will sign on to that statement forthwith because I believe that, but I also believe we need to work to earn it each day.

Mr. KANJORSKI. I appreciate that. One last question. After some 70 to 75 years of overall regulation of our equity markets, do you think it would be wise for the Congress to look at the overall regulatory scheme in the United States and compare it to other countries like the U.K.?

Mr. COX. I do, and I think that is a cognate of the question that Mr. Bachus was raising. I think to the extent that Congress can do that, particularly to the extent you can do it multi-jurisdictionally, across committees, and House and Senate, bicamerally, that would be a very good thing.

The CHAIRMAN. The gentlewoman from Ohio?

Ms. PRYCE. Thank you very much, Mr. Chairman. Following up on Mr. Kanjorski's discussion of competitiveness, I have three basic questions, all of them somewhat related. First off, Commissioner Atkins gave a recent speech and encouraged companies to look closely at the quarterly earning statements. The U.S. Chamber, and the Aspen Institute have recommended that companies move away from these statements toward more long-term planning, although you, I think, also stated that there is not a whole lot you can do rulemaking-wise, I often equate that same scenario to Congress, if we did not have elections every 2 years, we could do a lot more long-term planning too. So do you have any suggestions of what we could do or how we could help business to move away from this standard? That is my first question.

Second, there is a lot of talk on Capitol Hill now about raising taxes on private equity, some to the tune of a 133 percent increase. What impact do you believe that would have on our economy and competitiveness?

And the last question, Chairman Cox, when you were with us last May, you mentioned that market data was a front-burner issue for the Commission. You have several pending market data fee filings before the Commission. Do you have a long-term plan to resolve the approval of market data filings and what is the Commis-

sion's timing on those that are pending? And I just thought I would encapsulate all three and let you have at them. Thank you.

Mr. ATKINS. Okay, thank you, Madam Congresswoman. With respect to long-term planning by corporations, that is a theme that has come out of at least three reports that have been published in the last half year or more. And I think it is one thing that a lot of people identify as something that the public companies suffer from—that because they are trapped by the quarterly earnings statement, they shoot for the short term. I have heard that from a lot of folks in the private equity world as well. So, clearly one thing, along with what the chairman was talking about, that Congress can do is to study the marketplace. Do I have a clear answer to that? No, because it has to do with disclosure obviously to the shareholders and how that folds into the bigger picture.

Mr. COX. And I guess I can clean up and take the other two points that you raised. With respect to taxes, obviously, the Securities and Exchange Commission implements our securities laws, and we do not make tax policy. So I will make a more general observation that taxes on investment and taxes on public companies, as compared to private companies, can have an effect on capital formation. Our statutory mission includes the promotion of capital formation, so we have concerns about this. And I would encourage the Congress, as you consider tax legislation, to take capital formation and the impacts that the legislation might have on capital formation into account, particularly if the legislation is drafted in such a fashion as to discriminate between public companies and private companies, thereby discouraging companies from going public.

With respect to market data, we are considering market data as part of our broad review of the SRO structure, as you know. The review is intended to ensure that the regulatory structure for market data remains up to date and reflects such important developments as for-profit SROs and the expanding types of data that are needed by investors. Very recently, in December of last year, the Commission granted a petition from the Net Coalition to review the staff's approval by delegated authority of an NYSE ARCA proposal to begin charging a fee for its depth of book data. The staff is currently preparing a new order for the Commission to consider that would approve the fee primarily because NYSE ARCA was subject to significant competitive forces in setting the fee. In addition, the NYSE and NASDAQ since have filed proposals for innovative reference data products that make economic sense for advertiser Internet-supported companies, like Google, Yahoo, and CNBC.

Ms. PRYCE. And is there a timeframe you would like to discuss?

Mr. COX. Well, these are ongoing, and so I think you can expect developments in real time.

Ms. PRYCE. Real time, all right. Thank you. Would you like to comment at all—in some of the opening statements we heard mention of the amicus brief filed by the SEC.

[Gavel]

Ms. PRYCE. My time is expired?

The CHAIRMAN. Yes, but make it the last question and get a quick answer.

Ms. PRYCE. This is the last question. Do you want to comment on that now or would you rather have a more pointed question?

Mr. COX. Well, I need a more pointed question just to know which amicus brief you are talking about.

The CHAIRMAN. Go ahead and point.

[Laughter]

Ms. PRYCE. All right, the Stoneridge case, amicus brief, thank you.

Mr. COX. All right, the Stoneridge case, and you can get a variety of opinions here because, as you know, that was a three to two vote, but the Stoneridge case was very similar to a prior case that the SEC had considered in 2004 called Homestore. It was my view—and it is my view generally with respect to decisions that are recently taken by the SEC in precedent matters—that, because Homestore and Stoneridge were very much on all fours with another, I thought it important for the SEC to be consistent and be clear on these points. As I mentioned in my opening statement, I do not believe that SEC rules, our policies and so on, should be so effervescent as to change with one or two people coming on board. It would be awfully nice if the regulatory process were sufficiently transparent that people would know what to expect, and I think this is doubly so when what we are doing is trying to interpret law, what law means. Law has to have some objective meaning; it cannot be just a question of how we all feel about it. And so the SEC, having voted in 2004, just one year before I arrived, on this very point, I thought it important for us to be consistent. And I should point out that that 2004 vote was not a three to two vote, it was an unanimous vote of the SEC.

Ms. PRYCE. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. The gentlewoman from New York?

Mrs. MALONEY. Thank you. I would like to be associated with some of the many of the issues raised by Representatives Pryce and Frank and Kanjorski, but I would like to ask you, Mr. Chairman, about the front page today of the Wall Street Journal. It highlighted the growing risk from collateralized loan obligations, a product whose volume has doubled in the past year. And the Wall Street Journal calls them volatile and risky and the loan standards have loosened and lowered, and I wonder if you share that concern? More specifically, because there are no disclosure requirements for CLOs, investors do not know their value or the quality of the loans they represent. And up until now, the SEC has not regulated CLOs but it is my understanding that the Commission does have the authority under the law to require more disclosures and greater transparency for investors, and is it correct that the Commission has authority to regulate CLOs under the 1933 Act or other securities law?

Mr. COX. Well, the answer to your last question would be yes, if they were registered under the 1933 Act but, in fact, most of them are not.

Mrs. MALONEY. Well, if we had them registered, do you think greater transparency in these products would be desirable and important to safety and soundness?

Mr. COX. Well, there is no question that there is now a commonality of interest between the banking regulators and the securi-

ties regulators when it comes to issues such as safety and soundness, when it comes to overall issues of systemic risks throughout our economy and the health of our economy, the securitization of—

Mrs. MALONEY. How does the situation with the CLOs compare with the secondary subprime market, the CDOs, which are facing a challenge in our economy now? And do you think the same risks are present? Do you think that that market should be more transparent and regulated?

Mr. COX. Well, as I was about to say, I think that there are great commonalities because obviously the underlying risks stem from the same source. We come at these problems in many cases through our Division of Enforcement because of the overlapping regulatory jurisdiction. Our Enforcement Division currently has open about 12 investigations focused on issues such as this.

Mrs. MALONEY. Okay. I would like to follow up on the questioning of Deborah Pryce on the data information. And the SEC, in my opinion, took a bold step with regulation by opening market data up to competition and allowing exchanges for the first time to sell their own data. Three exchanges in New York, the New York Stock Exchange, AMEX and NASDAQ, and I would say many others, have innovative data products on hold and waiting for the approval from the Commission. And it seems to me that this delay deprives investors of innovative data products and deprives exchanges of their ability to compete with foreign markets. When does the Commission plan to rule on these pending proposals? You testified that you did not know when but could you give us a generalization, in the next year, in the next 6 months? And if not very soon, what additional steps are required by the Commission rules, what could we do to move this along? Competition between our markets and foreign markets are very, very important to our economy.

Mr. COX. I completely agree with that. What I said to Congresswoman Pryce was "real time" but to answer your question in precisely the terms you put it, months.

Mrs. MALONEY. Months. Is there anything else, any additional information you need in order to move this forward?

Mr. COX. Well, we are in the midst of a review that is inductive, we are learning as much as we can from marketplace sources. We have a good deal of public input, and we are constantly getting more. But I do not think other than that process we need more, no.

Mrs. MALONEY. Has my time—I would also like to talk about mutual fund disclosures. More than 90 million Americans are invested in mutual funds, and I think the Commission could do more to make it easier for individual investors to make comparisons among them. Last week, the SEC voted to expand its XBRL business reporting language, a pilot program, which will allow investors to use computer data tagging to make comparisons among funds, but it is very technical and difficult I would say for most individual investors. I would like to know what you are doing in this area. I know that at the last week's meeting, Commissioner Campos—

The CHAIRMAN. The time has expired, so please wrap up the question.

Mrs. MALONEY.—mentioned the need for the SEC to move forward with short-term innovative IPOs prospectus proposals that would be easier to understand and where do you stand on that?

Mr. COX. Well, I will let Commissioner Campos add to what I am about to say, but I think the whole Commission is very, very enthused about the prospect of improving mutual fund disclosure. We are focused on getting a simpler presentation for investors that focuses on decisions that they really need to make and the information they need to make those decisions. This is an area that is infused with retail participation, busy Americans with real jobs who have other things to do than look through big books of data. And so it is a very high priority for us, and I think that the industry is very much willing to participate in these initiatives.

Mrs. MALONEY. My time has expired.

The CHAIRMAN. Yes, it has.

Mrs. MALONEY. Thank you. Good to see you again.

The CHAIRMAN. And the gentleman from Louisiana is now recognized.

Mr. BAKER. Thank you, Mr. Chairman. Mr. Chairman, members of the Commission, I am appreciative of your work in the world of XBRL data tagging. I very much appreciated the demonstration of how it would work. As a long time advocate of that particular approach, however, I am anxious to see it more fully deployed in the world of public reporting. As you know, financial institutions insured depositories now report in that fashion. And I believe the taxonomy development is the limitation on more full deployment for XBRL for public operating companies. But as to another long-term interest, and that is elimination of quarterly earnings statements, I suggest to you upon further examination, as XBRL becomes more transparent and easily deployed, that that methodology would enhance the ease with which investors could get access to real time data as opposed to paper-based retrospective reporting, which is outdated by the time of its submission. And so I see the two very carefully married to one another and the outcome could be a very good benefit to investors.

Secondly, I am appreciative for the work on the Fair Fund, having some small paternal interest in that matter. I was pleased to see $1 billion had been distributed out of the $8 billion collected. And you note in your written statement that there are more significant announcements to be made. I hope those are statistically significant in relation to the $1 billion already deployed.

And to the principal reason for my questions today, although Ms. Pryce made indirect reference to it, as to your own view, perhaps not prejudicing the views of all Commissioners, that it must be a violation of a law or regulation that would precede an action by the Commission or an appropriate action in a court of law against that person who is presumed to have violated the rule or regulation or law that leads to a regulatory enforcement action or a financial award of some remedy at an appropriate time. The triggering device that leads to a regulatory or civil action against an individual, as a matter of legal judgment, do you believe that person should be at least be found guilty in the correct terms as the primary violator in order to sustain such penalties or a regulatory enforcement action?

Mr. COX. Yes, I believe that you are talking about the scheme liability case.

Mr. BAKER. I am.

Mr. COX. Yes. And I think it is very important to know that the liability that is being discussed in that context is knowing liability, intentional; it is fraudulent conduct, it goes beyond aiding and abetting. It is meant to be primary liability. In other words, the person can be charged themselves with the fraud, not in loose terms as an accessory.

Mr. BAKER. For example, if I am a vendor of a product to a customer, and I provide financial terms for the repayment of that benefit, and that underlying recipient of my product and financing arrangement inappropriately books that transaction in his accounting reporting and is found to have violated proper accounting standards, generally accepted principles, then it would not be a likely extension of liability to go to the provider of the product, who in good faith sold the product, enabled the financing to occur, and because the underlying management of the recipient financial transaction mis-reported, there should not be an extension of liability in that case because there was no willful intent to violate law, rule or regulation?

Mr. COX. That is exactly right. And a key point that you made in your hypothetical example is that the person is acting in good faith. They shouldn't at all, if those are the facts, be charged with securities fraud.

Mr. BAKER. I am going to surrender. As long as I get yes for an answer, I am very happy. Thank you very much, sir. I yield back.

The CHAIRMAN. The gentlewoman from New York, Ms. Velazquez?

Ms. VELAZQUEZ. Thank you, Mr. Chairman. Commissioner Cox, after you testified before the Committee on Small Business, I sent a letter requesting detailed information about the efforts that the SEC has made to quantify the cost of SOX for implementation under the proposed revised auditing standards and the new management guidance. As of today, we have not received a reply to my letter, so I am giving you an opportunity to share with us or I will ask any of the Commissioners if they are able to provide a specific estimate of the cost of SOX 404 for implementation under the new regulations on small companies?

Mr. COX. Thank you, Madam Congresswoman. The cost benefit analysis that we discussed in the Small Business Committee was published last week in the Federal Register. We are going to provide to you and your office a more expansive discussion of the specific questions that you had about that. The reason that there is not a dollar amount estimate for management guidance is that we will have the opportunity going forward to use the management guidance experience that we have with people already in compliance with SOX as a touchstone for making more solid estimates when it comes to people, smaller public companies who have not yet complied. I think it is also very important to distinguish between the costs—and there are very real costs that will be occasioned for smaller companies, when eventually they comply with Sarbanes-Oxley—that flow from having to comply with Section 404 as against those that are related to management guidance. Because

the statute, Section 404, is the source of the cost. The management guidance, on the other hand, is meant to mitigate that cost and reduce it. And so, to the extent that what we are doing with our OMB cost benefit analysis—

Ms. VELAZQUEZ. Commissioner, my understanding is that there is no estimate—

Mr. COX.—of the management guidance diminishes the cost, which is not estimated. The reason that is not estimated is that it is an act of Congress and Congress does not do that. When Congress passed SOX 404, it just passed it with no estimate.

Ms. VELAZQUEZ. You mentioned that it was published in the Federal Register last week?

Mr. COX. Yes.

Ms. VELAZQUEZ. And does it have an estimate on it?

Mr. COX. As I say, if you are talking about smaller companies—

Ms. VELAZQUEZ. Yes.

Mr. COX.—and the impact on smaller companies, because they will not come into compliance with SOX 404 until the following year, the experiential base that we will have with companies already complying with management guidance will give us a better touchstone for measuring and estimating the impact on smaller public companies.

Ms. VELAZQUEZ. Do you think it would be helpful for small companies to have a number, to know a number?

Mr. COX. Well, I think the number that you are looking for is the cost of complying with 404, and 404 is an act of Congress, it is not a regulation. It did not contain any exemption for smaller companies. All we can do is try and mitigate that cost, but we are not imposing any additional cost beyond the cost of the statute.

Ms. VELAZQUEZ. The final rule regarding the management report on Internet controls refers to a CRA international estimate that early compliance costs incurred by companies implementing SOX 404 range from $160,000 to $5.4 million per company. The SEC final rule goes on to declare that companies could experience a substantial benefit in terms of lower costs of compliance. So, for the record, I would like to ask each of you, one by one, to tell me how much these new regulations will lower costs of compliance for small companies?

Mr. COX. With whom would you like to begin?

Ms. VELAZQUEZ. With Ms. Nazareth?

Ms. NAZARETH. Well, I agree with what Chairman Cox said, that I do not think it would be appropriate for us to guess at this point how effective the mitigation will be under the management guidance. We obviously believe that it will reduce the cost, but it would be a better estimate if we waited until what the experience was with the management guidance in the next year in order to give you a better assessment of what the actual cost would be.

Ms. VELAZQUEZ. Yes, Mr. Atkins?

Mr. ATKINS. Well, there is no question that the costs of 404 implementation have been too high. Originally, back in 2003 I think it was, the SEC estimated about $94,000 per company, it is something like 20 times that for the rules as they were implemented. Hopefully, the new rules will be better but there is no question that the costs have been too high.

Ms. VELAZQUEZ. You do not think—

The CHAIRMAN. Well, I am sorry, we do not have time for further—we only have time for the answer.

Ms. VELAZQUEZ. Thank you.

The CHAIRMAN. We are over time.

Mr. COX. If your question is, do I think a number would be better, the answer is yes. And we want to base our estimate on real world data, which we are going to acquire in the coming year.

Ms. VELAZQUEZ. Mr. Campos?

Mr. CAMPOS. I think what we have done will bring costs down, but I agree with my colleagues that we need to have the experience base to come up with the number that you are looking for.

Ms. CASEY. And I would reiterate again that I think implementation will be key and our experience and whether or not we are going to get the cost savings that we anticipate will be very necessary to take decisions about how that will benefit smaller companies.

The CHAIRMAN. The gentleman from Delaware?

Mr. CASTLE. Thank you, Mr. Chairman. Going back a little to the earlier questions from the gentleman from Pennsylvania, with respect to the whole issue of recent IPOs and how many of them are not taking place in the United States, and a couple of the members in their opening statements blamed some of this on excess litigation and regulation, which I guess even incorporating would not overcome in some cases. But my question is, Mr. Chairman, do you consider that to be a factor, this whole business of excess litigation and regulation in terms of corporate activity in the United States?

Mr. COX. I do. Regulation has costs, so does litigation. Regulation—nobody thinks regulation is free. So the challenge is always to make sure that you are getting benefits that exceed the cost. Since we are administering a relatively stable but, in terms of the 21st century, ancient statutory system, as rulemakers, we have to constantly provide the grease in the wheels, if you will, to make sure that some of those ancient statutory concepts have some meaning in a high-tech global world in the 21st century. So we constantly need to sharpen our competitive edge as regulators in tune with the market and keep track of what is going on. Otherwise, our regulations are going to be excessively expensive.

The litigation aspect of this is to a lesser extent within our control, but we have to be very cognizant of it because what we do influences the climate. One of the things that the SEC has to be particularly attentive to is the degree to which conflicts of interest among people bringing litigation produce results that neither we as the regulator nor you as Congress would want in carrying out the statutory scheme. As regulators, we of course have one object, and that is to improve the lot of investors. We do it as public servants. We have no other motive. People who have a financial stake in the outcome—sometimes very, very significant—can act for other reasons; and yet they have the same power, through discovery and otherwise, to create a great deal of cost and expense. And we have to always be attentive to those risks in the system. That is one of the reasons that the Private Securities Litigation Reform Act was so important—because it made it very much more likely that private system, which was meant to extend the reach of the SEC in

important ways, patterns itself after the policies that Congress, and the regulator applying the will of Congress, seeks to obtain.

Mr. CASTLE. Thank you, Mr. Chairman. Let me change subjects for a minute, I want to go to mutual fund fees, which is a way many, many people in America are investing now. And I mentioned in my opening statement the 12b-1 fee sort of conundrum, as I look at it, which was once a methodology, as I understood it, to help mutual funds to be able to advertise themselves and then became sort of a broker compensation mechanism over some period of time, which is the way it is defended now, but that has not been changed as far as the way the law was originally written in the 1980's is concerned. Are you looking at that, and are you looking at any other fee aspects of mutual funds? You did mention interactive data, etc., that kind of thing, which I think would be helpful. But the whole business of understanding what it is that you are dealing with and what is out there with respect to mutual funds to me seems important.

Mr. COX. Well, I think probably most members of this committee, probably most of us Commissioners and everyone else in this room, owns a mutual fund or indirectly has some connection with mutual funds. It is a very retail space. We are all very concerned about understanding our choices and making sure we have our money wisely invested for all sorts of important future needs. So, as the regulator of mutual fund disclosure and to a certain extent promulgator of rules that govern what kinds of things can be charged from fund assets in the first place, we want to make sure investors are being treated right. There is a great deal more that we can do to make the purpose of fund expenses clear. There is more that we can do to make returns in mutual funds clear and to obtain the general disclosure that investors are looking for. So that has been the main subject of attention.

With respect particularly to 12b-1 fees, we just had a roundtable on this subject to consider from top to bottom what they are good for, what they are not good for, and what their future should be. And I think we got a great deal of very useful information, both substantively with respect to the purposes of 12b-1 fees and on the disclosure side.

The CHAIRMAN. The gentleman from North Carolina?

Mr. WATT. Thank you, Mr. Chairman. Welcome back, Mr. Cox, to the committee. Last year, the SEC proposed eliminating broker voting in all director elections by changing Rule 452. And you got some feedback and amended or resubmitted that to exempt mutual funds, which was understandable. However, we have not gotten any indication of what has happened with that since then. And our State treasurer in North Carolina—and we have had an experience in North Carolina where broker voting apparently or appears to, although we have not been able to get the full facts, have influenced or been decisive in who got elected to a board in a way that a lot of people are concerned with because CVS and Caremark merged.

So, I guess I have been trying to figure out some analogy to this. This strikes me at some level as being tantamount—allowing broker voting—to basically saying whoever does not vote in an election, their votes will be cast for the sitting incumbent, which might be beneficial to us as incumbents, but does not seem to me to be

all that democratic a process. Can you give me some estimate of the timetable on which this new proposal will be vetted and whether we will have a new standard by the next proxy season, can you just talk to me about that a little bit?

Mr. COX. Yes, I can. And you are right, this is connected to our proxy rulemaking for the next proxy season because it is bound up with the whole issue of how votes are cast and in what way shareholders participate in the proxy process. The New York Stock Exchange amendment that they have filed to their proposal to exempt registered investment companies from the proposed new prohibition on broker discretionary voting was filed with us on May 23rd of this year, relatively recently. But the overall question of not just broker voting, but also over-voting, empty voting and so on, was the subject of a roundtable that we held recently. And each of us here as Commissioners are very, very focused on the mechanics of the proxy system in the context of our pending rule proposal. The timetable is probably going to have us proposing next month, the end of next month, on the proxy rules generally. Whether we put questions out with that release or whether we do a separate release or just publish the NYSE rule proposal then remains to be seen.

Mr. WATT. Mr. Cox and members of the Commission, we had a markup this morning of a bill, a resolution I guess, that encouraged diversity in the financial services industry and this is an issue that I personally am very concerned about, diversity at all levels of the industry. What can the SEC do to encourage—what is the SEC doing first and then what can it do that it is not already doing to encourage greater diversity in the financial services industry and in other registered corporations?

Mr. COX. Our investor education mission at the SEC gets us out to a lot of places around the country. Commissioner Atkins, as a matter of fact, has probably logged more miles on behalf of that office than any of us, but all of us are very profoundly interested in that. We have a very aggressive diversity program at the SEC itself, which models and leads in this respect, but we also participate in private sector efforts to lead on diversity. And we think it is very, very important.

Mr. WATT. My time has expired.

The CHAIRMAN. Do any other Commissioners wish to comment on that?

Mr. CAMPOS. Congressman, I think all of us need to directly encourage Wall Street to look at the great resources in America in its diverse communities and in the diverse makeup of individuals. I think to the extent Wall Street does not have minorities and people of color in their ranks, they are missing out on a great resource. I think it is pretty clear, from all studies that are done today, that if you have a diverse group of individuals making decisions, you get better decisions, so it is a competitive item, it is not a charitable thing. And, moreover, capital needs to be allocated to the inner cities. Capital needs to be allocated in America where there are Third World returns available under our rule of law and for some reason Wall Street still does not hear that message. I think it is incumbent on us to make that message loud and clear.

The CHAIRMAN. The gentleman from California, Mr. Royce?

Mr. ROYCE. Thank you. Chairman Cox, I am increasingly concerned about the growing number of investor class action lawsuits and their impact on the U.S. capital markets. As I stated, in one of the studies I saw was Professor John C. Coffee of Columbia Law School, and he wrote that securities class actions essentially impose costs on public shareholders in order to compensate public shareholders. But on each such transfer, a significant percentage of the transfer payment goes to lawyers and other agents. It can run up to 40 percent. And he has suggested changes to securities class actions.

Now, I along with 15 other Members, have sent a letter to the SEC requesting that they examine several questions about the effect of these lawsuits. First, we urge the Commission to examine the costs and the benefits to the average individual investor of private class action litigation under the Federal securities laws.

Second, we urge the Commission to examine the cost of the benefits of class action settlements to the average shareholder, not only in terms of settlement payments but also transaction costs, including fees paid to attorneys, as well as a potential decrease in the value of innocent shareholders' investments as a result of the litigation.

And we urge the Commission to examine whether existing protection against professional plaintiffs are sufficient and whether the apparent link between political contributions and selection of counsel by public pension funds warrants a prohibition like the Pay-to-Play ban that was adopted in the context of municipal bond underwriting.

And, lastly, we urge the Commission to examine various means to adequately coordinate Fair Funds payments with related private class action lawsuits and make recommendations to Congress regarding appropriate legislative action on that front.

And I wondered if you would comment, Chairman Cox, on the possibility of the SEC undertaking such a study and reporting back to Congress maybe by the end of the year; it is just recently that we sent the letter.

Lastly, I had a question for Mr. Atkins. I was going to ask him—Mayor Michael Bloomberg and Senator Schumer combined forces there to put together that Committee on Capital Markets Regulation, and they released a report highlighting the need to do more if the United States is to remain the world leader in the financial services industry. And I was going to ask you, Mr. Atkins, if you believe that the SEC could do more to assist us in this objective and, if so, what do you think that would be? And maybe if you agreed with your colleague Mr. Campos' observation that Sarbanes-Oxley actually is attracting capital because when I was in London, I saw those signs that said, or that advertisement that said, "London is a Sarbanes-Oxley Free Zone." They were actually marketing the idea to investors because of the purported costs under Sarbanes-Oxley, so I was going to ask you, after Mr. Cox responds, if you would give me your perception on that? Thank you very much.

Mr. COX. Well, I guess I will start. Since you have used Professor Coffee as the foundation for the statements that you are making, let me say that he is greatly respected around the SEC, and his views are always worthy of serious consideration. One of the rea-

sons that the Commission is so aggressively using our Fair Funds authority is that we are very cognizant of the transaction costs that are built into private litigation. There is nothing anyone can do about those costs other than to the extent that fees might be more competitive or what have you, but there are big costs that are just built into private litigation. When the SEC is recovering and can distribute those monies directly to shareholders and cut out the middle man, those transaction costs are washed out, and the recovery to investors is greater. So the over $1 billion that we have been able to get back to investors since you gave us that authority, I think, is a signal victory for the policy that the Congress established and for the SEC in administering it.

We look forward to answering very formally the questions that you and other Members of Congress have put to us about the effect of lawsuits on investors, private class action settlements, transaction costs, the effect on innocent shareholders, and so on. And we will do, I hope, a very thorough job of it.

Finally, I think the Pay-to-Play rules in place are exceptionally important. That principle is a worthy one, and we will be happy to consider the suggestion that you have made.

Mr. ATKINS. Well, thank you, Congressman Royce, for your question. I read with interest the report that Mayor Bloomberg and Senator Schumer sponsored that was done by McKinsey and they have a lot of suggestions by which not just the SEC but also you in Congress can turn your attention to the costs of regulation here in the United States. And there is no doubt that litigation costs and regulatory costs do discourage issuers from coming here to the United States. You just have to look back to the Kennedy Administration, back in the early 1960's, to the so-called interest equalization tax that was imposed on securities transactions. That really helped create the Euro dollar market as people went to try to get away from that tax. So once you open that Pandora's Box, it is hard to get capital raising back here. So people do look at costs when they try to make decisions of where to issue their securities.

No doubt, as Commissioner Campos said, U.S. legal protections do attract investors from around the world, but they can also, if they are not in balance, work to repel people from coming here. I used to live and work in Paris, France, and I heard so many stories over there, similar to what went on here in Washington recently with the lawsuit against the dry cleaner, but also similar things that have people concerned about our litigation system. And I have heard the same sentiment recently from government officials, from public company officials and officers, people like that. U.S. investors over the last 40 or 50 years have had really the best of all worlds. We had a deep liquid market; we still do. Issuers from around the world came to issue their securities in the United States on our terms, under our laws, and with our protections. Now, as things have become more competitive, U.S. investors with a click of a mouse can invest directly abroad. We have to make sure that we have things in balance so that we continue to attract people to issue their securities here.

The CHAIRMAN. Thank you. The gentleman from California?

Mr. SHERMAN. Thank you. I have an awful lot of questions, and I would like responses for the record. I will go through those quick-

ly, and then focus on some that deserve an oral response. Looking at Sarbanes-Oxley, we have in effect two kinds of securities in this country. We have those that are publicly traded with all the maximum disclosure, legal costs and "Sarbanes-Oxley-ization," and then we have Regulation D, those securities not eligible for private invest—for public trading with limited numbers of investors and limited liquidity. I wonder whether you would work with us to explore the possibility of creating an intermediate level of security, one in which you did not have Sarbanes-Oxley in its full-blown form and in which there would be a public market but only eligible to or available to qualified investors? So that somewhere in between saying you have no liquidity on one hand or that your security was eligible to have the full repository of all the assets of widows and orphans on the other, that we would have an intermediate level that would be excluded from the more onerous parts of our Sarbanes-Oxley system?

Second, as to Stoneridge, I hope that you would provide for the record what you would like to put in an amicus brief if you were allowed to file such a brief, and also whether you think that statute should be adopted so that you can file an amicus brief on your own regardless of whether the Solicitor General agrees with or disagrees with it. As to that issue, I hope that you would focus on the interesting argument of the President, that it is the SEC that should pursue redress for injured investors. How would you do that if scheme liability were not available? And how would that affect your ability to enforce 10b-5? If we are going to take a whole group of wrongdoers and say that they are not liable for damages because they did not actually make a statement, are we going to be in a position where neither SEC nor private tort action can provide relief?

Finally, as to corporate law, this has traditionally been a matter for the States. Delaware falls over Nevada, which falls over Delaware, in an effort to race to the bottom and provide the least possible rights for shareholders and the most protection for entrenched management and to tell corporations they do not have to have cumulative voting. Should we have a corporation's code for publicly-traded corporations in this country and/or should we at least mandate that there be cumulative voting so that a minority group of shareholders would at least have one representative on the board?

Now, turning to proxy access, under the *AFSCME* v. *AIG* case, you have for a while suspended your no-action letters and in doing so, the world has not caved in, and I wonder whether you would want to continue this approach of allowing proxy access to those, especially those who want to change the bylaws so that they are then able to propose a slate of directors? Chairman Cox?

Mr. COX. Now, you said that you would like answers to many of those for the record?

Mr. SHERMAN. Yes.

Mr. COX. Which ones would you like me to address?

Mr. SHERMAN. I would like you to address that last question about proxy access.

Mr. COX. What we are going to do is put a rule in place because right now we have a decision from one Circuit Court of Appeals that has a different rule functionally in place than was in place in

the rest of the country. We need to make sure that there is one rule for the whole country, that everybody understands it, and that we have it in time for the next proxy season. I do not think that the relatively quiescent environment that we had for one year is going to last forever, we should not expect it to. Shareholders have every right to bring their proposals in whatever ways the law allows, and we just need to make clear what the rules are, so we intend to do that.

Mr. SHERMAN. Well, one last question, the Wall Street Journal reported that you are considering a proposal to allow corporations to mandate arbitration in securities class actions. Is this proposal under active consideration by the SEC?

Mr. COX. No, we do not have pending any proposed or other more mature rule or procedure governing this.

The CHAIRMAN. The gentleman from California?

Mr. CAMPBELL. Thank you, Mr. Chairman. And as the CPA in the room, I will ask an accounting question first.

Mr. COX. Did you not just follow a CPA?

Mr. CAMPBELL. As one of the two CPAs. As the only CPA in the room with an active certificate, how is that?

Okay, I will start with an accounting question. Chairman Cox, in your remarks, you talked about your proposal, the Commission's proposal last week regarding international companies or foreign-based companies that are listing on U.S. markets and the ability perhaps to use foreign financial statements. Obviously, what that is going to do, international accounting rules, is potentially create two different companies that are global companies that are competing with one another whose financial statements are both listed on U.S. markets or traded on U.S. markets, whose financial statements will be computed under different rules. Would it be desirable for us to move to a principles-based accounting system here? And, if so, what should we do to look at that? And, secondly, can we do it given our litigation structure, which we have just been talking a lot about and has been one of the problems that has migrated accounting rules from principles-based, which they were some years ago, into this very much rule-based accounting that we have today?

Mr. COX. Well, this whole debate about principles-based versus rule-based is very much at the center of attention around the world among global regulators and among market participants. The Congress has directed the SEC on multiple occasions, most recently in the Sarbanes-Oxley Act, to explore whether we cannot move to a principles-based system and how fast. So we know, in the wake of Enron, for example, that there was a great deal of attention paid to whether or not the complexity of accounting might not have been one of the contributing factors to people's ability to get away with fraud because they could technically purport to comply with all sorts of detailed rules; but, if you took a few steps back and looked at the whole picture, it was fraudulent. If you had a principles-based system, perhaps that might be a better way to get after the problem, and that is why, in SOX, that direction was given to the SEC.

Meanwhile, around the rest of the world, there has not only been movement on this front but rather decisive action taken so that in 2005, for example, the entire European Union mandated the use of

international financial reporting standards, which have gone from a standing start to very mature in record time. The United States has been an active participant in this. Paul Volcker was the head of the IASB initially. And now we have foreign companies filing, as you point out, in the United States on our exchanges with U.S. listings using IFRS. So at the SEC we are now getting experience looking at IFRS right alongside U.S. GAAP. This summer, the Commission expects to put out a Concept Release asking the very questions that you put and putting them out for public comment, and we are going to see what the marketplace participants, investors, consumer advocates, everyone else has to say about it.

Mr. CAMPBELL. Can we do it with our litigation—we have talked about this Schumer/Bloomberg report and that litigation is already a barrier to capital formation in the United States but if you go to principles-based, does that not become an even more ripe target for second guessing afterwards?

Mr. COX. Not necessarily. I infer, however, from the way you put the question that your concern is that people would like to be able to point, in the event of litigation, to a very specific rule that they adhered to in order to protect themselves.

Mr. CAMPBELL. Yes.

Mr. COX. And there is no question that is part of the yin and yang of all of this. On the other hand, as regulators, as policymakers here in Congress, we want a system that prevents fraud, not that cleans up the mess after it happens. And so we should do everything within our power to make sure that the system really achieves the objectives that we intend. And I think we have to constantly look at this and constantly strive to make ourselves better. Private litigation is a very important adjunct to SEC enforcement. We want it. It needs to be there. But I think every shareholder that gets involved in litigation would much rather not have the problem in the first place.

Mr. CAMPBELL. Right. Okay, one last real quick question.

The CHAIRMAN. Quickly.

Mr. CAMPBELL. Sorry?

The CHAIRMAN. Quickly.

Mr. CAMPBELL. Okay, just one very quick question, I believe you are looking at—there are all kinds of financial instruments that did not exist when the 1940 Act was put together, frankly there are some coming up that we did not think about 3 months ago, I know you are reviewing whether commodity index swaps are securities under the 1940 Act. Can you advise us as to the status of that and/or how you are going to deal in the future with all these new financial products that are coming up as to whether—which somebody is thinking up something right now that none of us are anticipating as to whether—

The CHAIRMAN. Why don't we get the answer now.

Mr. CAMPBELL. Sorry, thank you. Thank you, Mr. Chairman.

Mr. COX. Well, I think where you were headed was to the much longer list of cross-jurisdictional issues with the CFTC, all of these products that are coming up either on the futures or options market and what we're going to do about that. Because of the jurisdictional balkanization, if you will, that is based in statute, the best that we can do is work together. And so I have spent a great deal

of time with the Chairman of CFTC and our Commission with their Commission, trying to work these things out one at a time. And our staffs are very much rolling up their sleeves trying to solve these problems together.

There are very real markets and marketplace competitors that care a lot about these issues and for whom a great deal turns on whether something is or is not a security and whether it trades on one exchange or another. The margining is different. A lot hangs on this. And so we are under scrutiny and pressure when we make these decisions. But we want to make them as honestly and straightforwardly as we can.

The CHAIRMAN. The gentleman from New York.

Mr. MEEKS. Thank you, Mr. Chairman. I'm going to ask four questions and then just—they're quick questions, and hopefully you can answer them before the gavel. One of course deals with, you know, Mr. Feeney and I have sponsored a bill dealing with Sarbanes-Oxley. One of the concerns that the bill addresses is the communication between management or management's outside consultants and management's auditors in relation to management conducting its assessment of its internal controls. Question: How will the rules and guidance you just released affect that relationship so that management's assessment and the audit are more efficient and hopefully less costly? That's one question.

I also introduced—my second question is, I also introduced a bill with Mr. Tiberi on money market fund parity—H.R. 1171. This bill basically gives the ability of broker-dealers to use money market funds to meet their cash management obligations under the SEC rules. Shortly afterward, the SEC proposed rules to address the use of money market funds by broker-dealers, but it only addresses the 2 percent haircut, and not to use the money market funds for special reserve accounts, collateral, or escrows. Clearly, AAA rated money market funds have a spotless track record.

So my question is, don't you think it would be preferable to allow broker-dealers to use AAA rated money market funds that provide greater safety and better yields than Treasury-only money market funds, and are you prepared to go further and consider revising the proposed rule changes to incorporate the provisions of H.R. 1171?

The next question I had is basically, as I understand it, there's another rule change. What impact will changing the NASD bylaws have on small to regional broker-dealers after losing their ability to be fully represented on the NASD's board, were 43 percent of the—of almost all broker-dealers audited by the NASD within one year after signing a petition asking for an NASD investigation about threats against members? So that is my third question.

And finally, if you get a chance to answer it, I also understand that mutual fund sale charges have declined significantly since 12b-1 was adopted at that 12b-1 fees helped finance most of the administrative and other shareholder support functions that were previously performed by funds and are now performed by broker-dealers, and the other intermediaries who receive these fees. In light of this, what, if any, modification to Rule 12b-1 are necessary?

Mr. COX. Thank you for those four questions. If it's all right with you, I'm going to answer 1 and 4, and Commissioner Nazareth can answer 2 and 3, and we'll mix it up here a little bit.

You asked what impact our management guidance and the PCAOB's new audit standard under SOX 404 is going to have on the efficiency of audits and the relationship between management and auditors. It's a very important question and I'm very pleased to give the answer. The guidance and the new audit standards are going to make that process more efficient. That's what we intend. We're going to follow up to make sure that happens, and it's intended to occur in two ways.

First, the management guidance is coming from the SEC to the company concerning the company's obligation under the first half of 404, 404(a), to do its own assessment of its own internal controls. Absent that guidance, before we had it, all there was, was the standard for the auditors, and it made it much more expensive. It also put the auditors in the driver's seat when it came to that first part of 404, even though that's not the way the statute is written.

The second reason that it's going to be more efficient is that the audit standard itself is more efficient. And so the auditors aren't going to be forced to ask management to do things that aren't material to the ultimate financial statements that the internal controls are supposed to support. They're going to have an instinct for what truly matters, I like to say an instinct for the jugular rather than an instinct for the capillary. There will be a top-down approach, materiality-focused, risk-based and scalable for companies of all sizes.

We also want to encourage management and auditors to talk to one another, and there is no reason in what we're doing—

The CHAIRMAN. To get all four answered, we're going to have move a little quickly.

Mr. COX. All right. The second, just very quickly, with respect to 12b-1 fees, we just had a roundtable on these very questions to learn from the marketplace and all the participants, investors and others, what are the uses, positive and otherwise, that 12b-1 fees are put to, whether disclosure is adequate and where we should go. So we're right in the middle of that process, and we will have more to report to you on that very soon.

I will yield at this point to Commissioner Nazareth.

Ms. NAZARETH. I'll try to be very brief. I'll answer the third question first. You know, the NASD bylaws for the newly constituted organization were filed with the Commission. The Commission will need to consider whether they are fair in that they have representatives on the board for all types of broker-dealers. My understanding is that small broker-dealers are well represented on the board, but there's not one firm, one vote. It's done on a sort of stratified basis, so that firms of different types are equally represented. So I actually think that small broker-dealers are well represented, but they're not the only voice on the NASD board.

As to the money market fund parity that you discussed, it's an issue that the Commission is well aware of, and we put out for public comment a question on whether it's something we should address. We know that there have been requests for us to let money market funds be used in these ways, but we take these issues very seriously, because the provision of the regulations in which this comes up relates to the protection of customer funds by broker-dealers, and there's nothing that really has quite the same protec-

tion for customer funds as Treasury securities. There are no specific rules distinguishing among money markets funds or identifying which funds could be used for regulatory purposes. There could be issues in certain money market funds that should disqualify a fund from being used for regulatory purposes.

So, we're aware of the issue. The proposed rules are out for public comment, and we look forward to what we get back in the public comment.

The CHAIRMAN. The gentleman from Texas.

Mr. MARCHANT. Thank you, Mr. Chairman. Commissioner Cox, recently a Federal appellate court held against the Commission concerning the rule that exempts brokers from giving investment advice. I understand you did not file an appeal but went ahead and asked for some time for the compliance by the brokers. How is that process going, and will it be done by October?

Mr. COX. The reason that we didn't appeal was simply the legal determination that we made, and I believe in which the SG's office concurred, that the case would probably not be considered cert worthy by the U.S. Supreme Court. It was on that basis, not a policy basis, that the decision was made. And by the way, that's the way we always handle those decisions.

Going forward, because of the fact that this has now been dealt to us by the Court, we are moving as quickly as we can to deal with the real world situation. I'm trying to view this as an opportunity to revisit these issues and make sure that we have the most modern approach that most reflects today's marketplace as we do it. To give ourselves some time to do that, we asked the Court of Appeals for a stay of 120 days of its decision so that the status quo can prevail in the marketplace, and the Court has just recently granted that stay.

Mr. MARCHANT. Okay. On another subject, oftentimes the volatility in hedge funds is a result not so much of the long positions they hold, but the short positions that they hold. And my question is does this—is there any contemplation on the Commission's part to require the listing of these entities on their disclosures to ask them to disclose their short positions as well as their long positions?

Mr. COX. To the extent that you are speaking of hedge funds, I think our ability to require that kind of disclosure is exceptionally limited because they tend not to be publicly registered entities. And, to that extent, their disclosure that they make to their investors is a matter of marketplace negotiation rather than Federal mandate.

Mr. MARCHANT. What about the entities that file under 13(f), (d), and (g)? The entities that are currently filing their positions?

Mr. BACHUS. I think Commissioner Nazareth was prepared to answer the question.

Ms. NAZARETH. Well, I was just going to—

Mr. COX. Why don't you answer.

Ms. NAZARETH. Okay. As you know, we require the reporting of long positions because of concerns about change of control, and so we require the reporting of 5 percent ownership. We don't require reporting on short positions, partly because that information could

be used by manipulators, that is, used against the people who are holding the short positions.

One thing that we did, I believe, was recommend and vote to put out for comment recently with respect to the concerns about naked short selling was the idea of disclosing on a lagged basis information on fails—fail positions, so that investors could see what were the securities for which there excessive fails to deliver. But we don't have parity between short reporting and long reporting.

Mr. COX. And I just confirmed that under 13(d), those who are filing under 13(d), the reporting is the same for long and short.

Mr. MARCHANT. Okay. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you. Mr. Moore?

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman, and thanks to the Commissioners for being here. Chairman Frank and Mr. Sherman asked questions about the issue of proxy access. I've heard the SEC might be considering either a threshold amount of company holdings or a holding period as a way of conditioning proxy access, and I understand the interest in discouraging frivolous proposals by small or short-term holders, but I would—it would concern me if the SEC promulgated restrictions that would prohibit most shareholders from accessing the proxy.

Chairman Cox and Ms. Nazareth, would you care to share your thoughts on this issue?

Mr. COX. Yes. Just to remind you of the schedule, we expect to propose a rule for public comment, start it on a process that will take several months, probably at the end of next month. The Commission is still very much actively engaged in discussing what that proposal will look like. I think, just speaking for myself, that I would share your concerns about the Federal Government coming up with very particularized rules about how things ought to operate when fundamentally they are matters of State law. So a national bylaw, as it were, is not the kind of approach that I would favor.

Mr. MOORE OF KANSAS. Ms. Nazareth, do you have any thoughts you'd like to share?

Ms. NAZARETH. Well, I would agree that a rule that would allow shareholders more meaningful participation would foster more responsible behavior by boards and bolster investor confidence in the integrity of our markets, and so I also support the notion of addressing the proxy access issue as soon as we can.

Mr. MOORE OF KANSAS. Thank you. Thank you, Mr. Chairman.

Mr. PRICE. Thank you, Mr. Chairman.

The CHAIRMAN. Sorry. Did we not get the gentleman from New Jersey? The gentleman from New Jersey first.

Mr. GARRETT. Thank you. And thank you again. This week, as I made reference to in my opening comments, I made reference to a bill that I had. But this week I will be offering an amendment to the Financial Services appropriations bill. And what that amendment will do is what my other legislation would do, and that extend the current exemption for small businesses to comply with Section 404 of Sarbanes-Oxley. The amendment would in essence prohibit the SEC from forcing the small businesses to comply with 404(a) for the fiscal year 2008.

If any or all of you would just comment on the fact that in light of the fact that we're here in this year with the change in the rules and sort of you might say in the middle of the game, why we should not be extending this exemption and giving the smaller companies who are not—don't have the wherewithal as the large companies do to deal with this issue right at this point in time. Why shouldn't we be extending it at this point?

Mr. COX. I think we should. I think we need to give smaller companies more time. That's why the SEC for the fourth time has extended it now all the way into 2009. We've broken up the requirement for smaller companies to comply with 404 into two phases. In the first phase, they will do only the management assessment part—

Mr. GARRETT. Let me rephrase my question.

Mr. COX. Yes.

Mr. GARRETT. Then why shouldn't we have the continuous extension for the entire element of 404 and not the broken up point as far as you've done?

Mr. COX. Well, I think that the expense, as we have judged it, comes from the auditor's attestation to the management's assessment. As I mentioned earlier, many other countries, including the U.K., have the 404(a) piece, but we're the only nation on earth that has 404(b). That's where the friction has been, and that's where we're trying to focus our remedial efforts.

Mr. GARRETT. Any other Commissioners want to—okay. Then picking up on your one comment with regard to the expense, apparently—and I apologize for not being able—the chairman knows we can't be at two places at one time on these things.

Someone else I guess from the committee asked the question as far as whether any or all of you are able to pinpoint or within a range the actual cost savings that we could potentially see from the new rules that are coming down. And correct me if I'm wrong, the testimony was that you were not able to give a range for that. Is that—

Mr. COX. I think what we said was with respect to smaller public companies, that we have not made a specific dollar estimate, but that instead what we hope to do is to base an estimate going forward on the real life experience that we'll have over the next year when the new management guidance and the new audit standard, AS5, are actually put in place.

Mr. GARRETT. And if—first of all, if during that period of time and the real life experience comes out but you're really not seeing the savings that you anticipated, then will there be a rollback as far as implementation of those rules on the smaller companies? And if there is, what would be the threshold that you'd be looking at as far as cost savings for these companies?

Mr. COX. Well, first let me say, that's not our plan. But, second, we have to be open always to the real world evidence that comes before our eyes. So we will be very attentive. We're extremely interested in whether or not we have achieved the intended objective here of significantly reducing costs.

I will say that I've gotten some episodic information about companies renegotiating their audit contracts with their auditors using the new AS5, even though it's not in force yet; the SEC hasn't yet

finally voted on it, but the PCAOB has, and it's out. The public knows what it looks like, and they have reported that they have been able to reduce their 404 costs by 50 percent in one case for a large company.

If we get enough evidence like this that we're successful, then I think we would stay on the schedule that we have announced.

Mr. GARRETT. Well, in your report, you cite a study by CRA International that states that the average cost of compliance for a small company with market cap between $75 and $100 million—$700 million is costing $860,000 a year, and of course that's broken down into the second year as opposed to—essentially the second year after the first year of implementation.

Is it also your understanding that you are not required, because this is a rule from Congress as opposed to a regulation, to comply with SBRFA then as far as if the amount of savings is under 1 percent as opposed to over 1 percent reporting back?

Mr. COX. No. I think that earlier, I was simply trying to parse what it is that we're accounting for and what we will always estimate is the effect of our rules, the costs and benefits of them, the cost, if you will, of management guidance we expect is negative. We expect it's ameliorative. It's going to reduce the cost of compliance, so that the costs that are being imposed are not from the incremental decisionmaking of the SEC to have management guidance or the PCAOB to have a new audit standard. Rather, those costs are imposed by Section 404 of Sarbanes-Oxley itself. And by changing the way that it's applied and reducing that expense, we hope to have—

Mr. GARRETT. Does it—

The CHAIRMAN. I'm sorry. We have too limited time for another question. The time has expired. I'm now going to go to, because the gentlewoman from New York has been here very faithfully, but she had previously agreed to give up her time to the gentleman from New Hampshire. She has graciously agreed to give up her time, so I will now go to the gentleman from New Hampshire, then we'll resume the regular rotation.

Mr. HODES. Thank you, Mr. Chairman, and I thank the gentlewoman for yielding me the time. In looking at the Blackstone deal in the IPO, I found some things that were quite confusing. Blackstone seems to be made up of direct and indirect interests in hedge funds, private equity funds, and real estate funds. And under this arrangement, they claim that their holding company is made up of only 22 percent of assets. However, through indirect holdings, this appears not to be the case. In fact, it looks as though, as defined in the 1940 Act, interests in investment securities constitute 85 percent of their assets.

And we put up a chart which I've called Chart 1, which is taken off the SEC Web site and was in the Blackstone filings. And it appears that Blackstone is a loose association of companies. Investors are buying pieces of a limited partnership whose cashflow is derived from pools, which are at the bottom of that chart. And regardless of how it registers with the IRS, it seems to me this is an investment company.

Now it's important because of issues of transparency, accountability, and fiduciary duty. Because the 1940 Act requires compa-

nies to adhere to fiduciary duties to their public investors. I went into the offering documents and looked at Form S–1 filed with the SEC at pages 179 and then 182 to 185. In those documents, Blackstone explicitly disclaims any fiduciary duties to investors in the IPO that it might otherwise owe under the State law of Delaware.

Now let's take a look at Chart 2, which is actually, frankly, a simplified version of Chart 1. And I apologize to those to my left who are blocked by the chart. Now the cloud in the middle are the holding companies, and it's a cloud which in my view needs to be more transparent. I think investors need more information on where their money is going.

I'm also extremely concerned about the potential national security risks of this deal, because the 1940 Act requires companies to adopt key investor protections, including mandatory disclosures about the nature of their assets, and Blackstone has not disclosed what the underlying assets of this entity are in any meaningful detail. In looking at the deal, I was surprised to learn in press reports that the Chinese government has bought a 44 percent stake of what Blackstone has offered to the public, owning $3 billion worth of nonvoting shares at a preferred rate, while Blackstone's S–1 forms submitted to the SEC simply talk about a State investment company, never mentioning the word "China." So I have serious concerns about China's ownership of Blackstone's holdings, because the holdings include companies that provide software and applications for use by the military and satellite technology, and I consider the lack of disclosure unacceptable.

So, given the precedent that this private equity going public filing has, and we expect to see a lot more of these kinds of filings, and given the increasing number of Americans who are investing in securities, as you point out, the structure of Blackstone looks like an investment company, whose disclosures are incomprehensible, and it owes no duty to its investors. The message that emerges is, as long as you create a complex enough corporate structure, you can evade the Investment Company Act of 1940.

Now I hope you agree that this is not how that Act should be interpreted and enforced. I'd like to know what steps the Commission is taking to ensure the integrity of the Investment Company Act of 1940 in the context of this offering, whether you believe the Investment Act of 1940 is adequate for you to regulate, and if it is inadequate, to impose fiduciary duties on Blackstone, do you agree that legislative action is necessary? Do you want to wait for the lawsuits that would be inevitable that my colleagues on the other side of the aisle seem to feel so bitterly about? Or are there other remedies available to the SEC to deal with the issue? And the crux of it is the fiduciary duties.

Thank you, Mr. Chairman.

Mr. COX. Thank you, and I think you've elaborately laid out a great many questions. Let me try and address as many of them as I can get at here. First, I am advised that the Chinese stake was in fact explicitly disclosed, and that China does appear in the S–1. It may not have appeared at the portion that you focused on, but it is, I am told, plainly disclosed.

Second, the role of the SEC in doing all of its review of the S–1 was not to evaluate the merits of the transaction, the propriety

or advisability of the structure of the transaction, but rather determine whether the company's filing met SEC requirements for disclosure. Those requirements are designed, as you know, to make sure that all material information, positive or negative, is presented to investors. When the staff made the decision to grant Blackstone's request to declare the registration statement effective, the SEC had no reason to believe that Blackstone's disclosures were not in full compliance with the Federal securities laws or that the public was not fully advised about the potential for, for example, a different tax treatment or about the Chinese ownership stake, which you mentioned.

In the process of the Division of Corporation Finance's review of the S–1, we referred it to the Division of Investment Management to consider the Investment Company Act questions that you raise. They determined under the Investment Company Act that Blackstone doesn't meet either of the two most relevant tests for determining whether it is an investment company. Specifically, it is not, they determined, and does not hold itself out as, primarily engaged in the business of investing in securities with its own assets. The funds that Blackstone manages are indeed investment companies, but the fund manager is not under the law.

The second test was whether the issuer was engaged in the business of investing in securities and owns investment securities exceeding in value 40 percent of its total assets. Based on the information in Blackstone's registration statement and additional information that was provided by Blackstone at the Commission's request, Commission staff determined that the value of Blackstone's investment securities was less than 40 percent of its total assets.

Mr. HODES. Thank you.

The CHAIRMAN. The gentleman from Georgia.

Mr. PRICE. Thank you, Mr. Chairman. I appreciate that. I don't have any charts, so my questions may not be as clear. However, I want to talk a bit about settlement extortion and the consequences thereof.

My understanding that over 75 percent of the IPOs that are started now are offshore or not in the United States worldwide, and there's a reason for this. There are a lot of reasons for this. One of them I believe to be the threat of liability. Settlement figures and security class lawsuits are clearly on the rise. The amount of money that was agreed to in settlement over the last 10 years, my understanding is, was greater than $43 billion. That's in settlements. If you exclude Enron and four other mammoth settlements in excess of a billion dollars, the average settlement in 2006 was $45 million, which is twice the average in 2005.

Multiple analyses have looked at this. A recent NERA study showed that settlements increased with the depth of defendant's pockets, with big claims in deep pockets seemed to be leading to larger and larger settlements regardless of the merits of the underlying claims. So my question would be, what do you believe can be done, if anything, to ensure that securities class actions provide fair compensation to the injured investors rather than simply a tool for extortion by plaintiff's lawyers?

Mr. COX. Well, it's a very broad question, and it highlights the negative aspect of what also has a lot of positive aspects. Obvi-

ously, every shareholder deserves redress, and we want to make sure we always have a system in which people can bring their claims, have them adjudicated and get what the law says they are entitled to.

There is so much money involved in many of these lawsuits that, as in all things in which a great deal of money is involved, as we find out to our chagrin every day at the SEC, there is always fraud at the margin. We want to make sure that when that occurs, we have ways to deal with it. So it starts obviously with the Article 3 branch. Judges have to be very attentive to this. Congress has played a role in this with the Securities Litigation Reform Act, which gave judges new tools. We want to make sure always that those precepts are followed so that the interests of investors are put first.

Mr. PRICE. Do you believe any action is needed by Congress or by the SEC at this point in this area?

Mr. COX. Well, you know, the SEC did in fact file an amicus brief with the Supreme Court in a case that involved the Securities Litigation Reform Act to make sure that the yang of the yin and yang here is also always kept uppermost in mind. And we will continue to do that. We've filed over two dozen briefs since the Securities Litigation Reform Act was enacted. That's part of our charter, because under the securities laws, private litigation is meant to carry out the public purposes that the SEC itself is charged with enforcing.

Mr. PRICE. You would agree that the public purposes are carried out when the awards or the monetary settlements reach the investors that have been harmed to the greatest degree, would you not?

Mr. COX. Precisely.

Mr. PRICE. Let me move to executive compensation if I may. We've moved a bill through this committee to address that issue. It's my belief that the SEC's new disclosure requirements, which are being implemented, are a major step in the right direction, and I wonder if you might offer an opinion as to whether or not you believe any act by Congress is needed at this time until we see the results of the disclosure requirements that the SEC has put in place.

Mr. COX. We are, of course, very, very busy ourselves being inductive about what's going on in the real world with this new disclosure, how are people handling it, is it exactly what we hoped it would be, and so on. We don't know the answers to those questions yet, but we're going to make a full report very, very soon.

I'm very acutely aware of the difference between my role now as one who administers the laws rather than one who makes them, and we will be very respectful of any guidance that Congress gives us on these subjects.

Mr. PRICE. I want to quickly move to—and I appreciate that. I think it's important that Congress not act until we see the results of the work that the SEC has done. I want to move very quickly to the issue of regulation. Dual regulator, we divide our regulation into two categories, securities and futures. And I wondered if you might have any opinion regarding the ease of efficiency for the SEC or elsewhere that might be benefitted by a single regulatory scheme.

Mr. COX. Well, such a scheme exists in other countries. I don't know if Commissioner Campos wants to comment on his extensive international experience, but it sometimes produces puzzlement when we deal abroad, when people have to understand how we do it somewhat uniquely in the United States of America. We have, on the other hand, very understandable historic reasons for our setup, and there are also some very realistic things we have to take into account about how difficult it might be even for the Congress to try to undertake a revisitation of that jurisdictional allocation. So—

Mr. PRICE. Efficiencies might be gained, though. Would you—

Mr. COX. I don't think there's any question that anything that you can do to rationalize the treatment of what should be competitive products across the different markets would be a good thing for capital markets and a good thing for investors.

Mr. PRICE. Thank you. I yield back.

The CHAIRMAN. The gentleman from Texas, who graciously filled in for me.

Mr. HINOJOSA. Thank you, Mr. Chairman. I wish to address my question to Commissioner Campos. I am delighted to see you here as a panelist. I happen to represent Harlingen, your home town, and I am delighted to see you here as one of our presenters.

I understand there is a pilot program underway allowing options to be priced in the penny increments rather than in nickels.

I also understand that the results so far have been promising and have narrowed spreads for investors, thus, saving money.

Please share with us your thoughts on expanding the pilot program to additional issues given the savings to investors.

Mr. CAMPOS. First of all, I know that Harlingen is in good hands, Congressman.

That particular program, that pilot, is going well. I think our staff is very busy studying the results. We believe that there will be opportunities to expand that pilot further, and we want to do it carefully and in a way that is appropriate given the costs, given the broadband that is necessary in this particular area.

Mr. HINOJOSA. Does your budget have enough money to expand it, double it possibly, in the future?

Mr. CAMPOS. I would assume we have enough for that. If not, our Chairman is very capable of coming to you and asking for more.

Mr. HINOJOSA. As many of you may be aware, Congresswoman Judy Biggert and I co-founded and currently co-chair the Financial and Economic Literacy Caucus. Its goal is to improve financial literacy rates for individuals across the United States during all stages of life, and the SEC is a member of that 20 agency strong financial literacy education commission.

As such, I have heard many good things about your financial literacy program as well as those of the Federal Reserve.

My question then would be to Chairman Cox, what programs do you currently have operating financial literacy across the United States?

Mr. COX. It is a pleasure to be able to talk about them and brag about them. Our Office of Investor Education and Assistance is really the front door to the SEC for many individual investors. Besides handling all of our retail interaction, positive and negative in-

vestor complaints and suggestions and so on, we have investor education initiatives that we take on the road.

We have almost weekly, certainly monthly programs that we are sponsoring or participating in around the country. We have 11 offices, of course. We also go to places where we have no offices at all to participate in investor education and financial literacy initiatives.

We partner not only with other levels of government, but with private sector organizations in seminars devoted to adult education and school age education when it comes to financial literacy. We work with public libraries and schools to put out brochures and the sorts of things you can also get directly on our Web site.

We have a very expansive SEC Web site devoted to financial literacy and beyond the information it contains, it links to still more places where investors can get information.

Mr. HINOJOSA. Chairman, that is a good answer, but let me tell you where it is not working. The savings percent throughout the country has dropped from a positive 3 percent to a negative 1.5 percent.

If we are going to be able to measure how this program is doing, it would get a very negative or at least an "F." We are going to need the partners to work with us to see how we can turn this around and get back up into the positive.

Seeing that my time is almost up, Mr. Chairman, I am going to yield back.

The CHAIRMAN. I thank the gentleman. The gentleman from Florida is now recognized.

Mr. FEENEY. Thank you, Mr. Chairman. Welcome to all the Commissioners. I share the concerns that have been expressed by a number of my colleagues about American international competitiveness. I have had a good deal to say about it, as Congressman Meeks said, we have a bill that would fundamentally and radically change the way Section 404 is applied.

I am concerned that perhaps the lack of willingness to let smaller companies—I have defined that in our bill as $750 million in capitalization or less, for example, are under the gun. I think that has a lot of unintended consequences.

Chairman Cox, I know you have concerns as well. I have a lot less patience probably than you with respect to what I perceive to be the loss of American capital leadership, which is pretty dramatic.

Before SOX was imposed, something like 90 cents of every foreign IPO that raised money was doing it in the United States capital markets. Just last year, there were 557 non-U.S. company IPOs in the London Stock Exchange, and just 28 non-U.S. company IPOs in the New York Stock Exchange.

By a 95 to 5 ratio in that specific instance, we totally flipped the odds from nine to one to in some cases nine to one. It is not just the—by the way, I talked to Chief Financial Officer Tong in Hong Kong, and asked him whether or not a Hong Kong capitalist going public would consider listing on the U.S. markets as opposed to Hong Kong, and he laughed at me. He said that after Sarbanes-Oxley, they would not even dream of such a thing.

The evidence is anecdotal. It is significant.

Chairman Cox, as I understood it earlier, you said during the extensive debate on Section 404, that there were no specific estimates given about the cost of 404 compliance.

In fact, and I was not here at the time, but I have gone through the record, and there was no debate about 404 in this committee; 404 was added in the Senate. We did not have hearings over here.

The SEC actually filed a document in the Senate proceedings saying that they estimated the aggregate amount of costs to implement 404(a) of SOX would be around $1.24 billion; in fact, it has been on the order of 20 to 30 times that.

Even by government standards, being off by a factor of 20 or 30 is not really good work. With all due respect to the Commissioners, you have now said that you are going to decline to give an estimate of what the compliance costs are likely to be, although finally, we are at least looking at costs versus advantages.

I have a huge concern if we have no idea now what costs are going to be that we still have these smaller companies under the gun. I have concerns about other aspects.

Given the Committee's testimony that we have this brand new auditing standard to streamline and improve the audit of a company's internal controls, brand new, we do not know what the costs are going to be imposed, and yet we are insisting that as of 2009, we are going to require all these companies—I think you are going to continue to see companies by and large flee U.S. markets for overseas markets.

You are going to continue to see companies de-list. The thing you do not see is the potential companies that might go public, to their advantage and to the advantage of investors. We do not know how to quantify that loss to the American economy.

One study published, not conducted but published, by the American Enterprise and The Brookings Institute says that the indirect costs on the U.S. economy for loss of opportunity is on the order of $1.1 trillion a year.

If 100 economists do that study, we will get 100 different answers. If they are even close to correct, it is about a 5, or in that case 10, percent tax on the American economy merely because of Section 404, which was never even debated in this committee.

I guess I would like to have your response to that. By the way, I want to weigh in on Stoneridge. I am really upset given the universal understanding that litigation burdens in the United States is another detriment. That is another matter.

I will let you respond to my rant and rave on the lack of aggressive reform of 404.

Mr. COX. I cannot take, as Chairman of the SEC, responsibility for the infamous estimate, the cost of 404, because I was in another place responsible for Sarbanes-Oxley itself as a member of the conference committee in the House and the Senate, as were many of the colleagues here on the committee.

You are absolutely right that none of us expected that 404, the language of which had been borrowed from the FDIC Improvement Act, would have dramatically different consequences when applied generally to corporate America than it did when it was applied to banks.

My diagnosis—and I think this is something that my colleagues would probably agree with—is that the big difference was that we had a very elaborate audit standard put in place to implement 404 that did not exist with FDICIA.

The audit standard itself was not only used for the auditors, but it was also used as a proxy by management because there was no separate guidance for management on how they should do their part under 404. And that made what was already an expensive audit standard even more expensive.

What we have done, including 2 years of work, is for the first time provide guidance directly to management that is very simple and straightforward and easy for them to understand, that does not involve them in having to reverse engineer the long audit standard that was meant not for them but for auditors all along.

Second, the Public Company Accounting Oversight Board, a SOX creation, as you know, which promulgated the original audit standard, has completely repealed it and replaced it with something that is much shorter, half the length, written in plain English, top down, risk based, materiality focused, and scaleable for companies of all sizes.

We expect that the combination of this management guidance and the new audit standard from the PCAOB will dramatically improve the ability of companies of all sizes to comply with SOX 404 in a cost efficient way.

You are absolutely right that was not the case previously, and that is why we needed to do all this work.

The CHAIRMAN. The gentleman from Missouri.

Mr. CLAY. Thank you, Mr. Chairman. I thank the Commission for appearing before the committee today. It is good to see the Chairman back in this room where he had done so much work.

Let me first ask Ms. Casey a question. I understand that industry-wide, there are over one million client accounts that will have to be transferred. That means one million client contacts, one million clients consenting to changes, and one million headaches.

Do you believe that October 1st provides a sufficient amount of time for affected entities to make contact to their clients, receive the necessary consent, and deal with the paperwork and technical challenges that are involved in transitioning accounts?

Ms. CASEY. I appreciate the question, Congressman. As earlier mentioned by the Chairman, the Commission is actively working to try to address the impact of the Court's decision and minimize what will definitely be a significant dislocation for as you note, a million account holders.

I think that as we noted, the Commission had also anticipated some of the broader issues that we would have to contemplate by seeking a study by Rand on some of the considerations that we should take into account as we look to the changing nature of the marketplace as far as investment advisors and broker-dealers.

In the short term, however, I think that we are very keenly focused on trying to address the issues of dislocation and work with the industry to ensure that we are able to adjust to the decision effectively, and again, I think the grant of the stay will significantly help us do that.

Mr. CLAY. Thank you for that response. Chairman Cox, you stated in a speech last July regarding the Commission's soft dollar initiative that, "Today's interpretative release brings our guidance up to date and removes some of the uncertainties about how this 30 year old law applies in the current environment."

You also noted that, "The release clarifies the rules that apply to Commission sharing arrangements among money managers, brokers and third party research providers.

It gives the industry needed flexibility to structure a variety of arrangements consistent with the purposes of the statute. This flexibility will contribute to improved efficiencies in the marketplace for research, which will directly benefit investors."

What has happened in the year since the interpretative release to warrant a call for fully repealing the safe harbor provision, and are you indicating that there are no further steps the Commission can take to add clarity to the provision, or are further changes currently under discussion at the Commission?

Mr. COX. Thank you. Further changes and further clarifications are possible from the Commission, for example, in the disclosure area.

At the same time, what the Commission can do in overall flexibility and freedom of action here is limited by very specific statutory provisions of Section 28(e); and, to the extent that we are going to address the fundamental issues of conflicts of interest, potential for higher brokerage costs, difficulties in administration, and hindrances generally to the development of efficient markets, Congress is going to have to look at that.

What we do is we administer the laws as we find them in 28(e), which as we all know relates back to the situation 30 years ago when we unfixed brokerage commissions and is a fixture unless Congress addresses it.

Mr. CLAY. Thank you for that response. I may have time for one more question. I am aware that the Commission recently held a roundtable discussion on the issue of Rule 12b-1. I understand that the rule has proven an extremely effective method of increasing mutual fund investor choice and paying for mutual fund distribution.

Can you tell me what prompted the Commission to hold the roundtable?

Mr. COX. Yes. Since the rule was put in place, a great deal has changed. The original context in which Rule 12b-1 was adopted was one in which the mutual fund industry was in its infancy. It was in fact a period of net redemptions. There was some concern that the industry might suffer crib death.

It was thought important—because mutual funds were thought to be a good thing—that there be an allowance made, particularly to deal with temporary imbalances, to use fund assets in order to promote the sale of shares in the fund to other investors.

Things are very different now. The industry is very, very mature. At a minimum, it is high time that we take a top to bottom look of the original purposes of the rule, the way it has morphed into something very different, and whether or not we have it right.

Mr. CLAY. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Illinois.

Let me just say to the Commission, we are very grateful. I know we have been here for 3 hours. We only have a few members who have been very faithful, and I think we can clean this up in about half an hour or so, if that is possible, we very much appreciate your indulgence. We want to be respectful to the members who stayed.

The gentleman from Illinois. Thank you.

Mr. ROSKAM. Thank you, Mr. Chairman. Long time listener, first time caller, this afternoon.

Mr. Chairman, this past week, I have been to two baseball games out at RFK. I saw the Nationals lose to the Detroit Tigers. Last night, a far more exciting game, the congressional game. I paid a lot of attention to the umpires when they were there. It strikes me that your demeanor today transitioning from your role as a policymaker to your role now is, really, you are calling balls and strikes.

I noticed in the earlier conversation that you had with Mr. Kanjorski from Pennsylvania, your careful use of language. I mean that respectfully, not parsing use of language, but careful use of language. How you characterized the American economy as robust and dynamic and so forth, and that you would sign onto that characterization, but you also said hey, there is more opportunity for us to improve.

You also used that same admonition to the Congress about well, let's make sure there is a sense of equity between public company taxation and private company taxation or private equity taxation.

Of course, people like me, we all tend to hear in your words what we want to hear and I think you will probably see quotations later on about how we have interpreted what you have said in different debates, and in the months to come, we will all recollect, well, we had Chairman Cox here, and he said, and we will have different recollections of that.

One of the things that is interesting to me is your high view of what you did not say but what I think is the doctrine of stare decisis, and your decision to move forward with a request in the Stoneridge case, to move forward with the amicus brief request and so forth.

Can you just give me your thinking on that? Was that a decision that was look, I have this new role, and stability is very, very important here, and I understand that thinking, or alternatively, do you believe first and foremost that animating the plaintiff's bar in this class action type of environment helps the SEC to do its enforcement, or is there some rationale in between there?

Mr. COX. First, thank you for your compliments. I think your interpretation of what I have been attempting to get across here today is fairly accurate, including the priority that I place on predictability in rulemaking and enforcement from the Securities and Exchange Commission.

I think it is absolutely vitally important that our actions be knowable in advance. Otherwise, there is not law, but something else, a lot of government power being exercised arbitrarily.

I do not think there is anywhere where it could be more important for there to be predictability and clarity in rulemaking than when it comes to our capital markets because so much is at stake. People have to make big bets whether or not what they are doing

is the right thing to do and they need assurance that they have it lined up the right way.

I think we do a great disservice when we do anything but clear and predictable rules based and law based.

That is not to say this was an easy case or there was an automatic outcome. I think you also put your finger on the fact that sometimes getting it right means undoing what you have done once before.

I did not reflexively follow the unanimous decision of 2004, but rather looked carefully at what was before me.

The staff recommended that the Commission request the Solicitor General's Office to file an amicus curiae brief, as you know, in support of the plaintiffs in Stoneridge. On May 29th and 30th—because we have a seriatim process, it occurred over 2 days—the Commission voted to approve that recommendation.

I think it is probably not well known that there were two parts to that recommendation in support of the plaintiffs, and, on one point, the Commission was unanimous.

I think all of us paid a great deal of attention to, as you put it, STARE decisis, and all of us paid a good deal of attention to whether or not we had it exactly right. We came out slightly different as Commissioners, well, exactly opposite in the end, although these are closer calls, as you know, then when you push the red button and green button, you are completely one way, and that does not mean it is always easy.

I think everyone here, whichever way they decided that case, and they are all here, so you can ask them, but I think everyone here is concerned that litigation be used to proper ends, and that we not open a Pandora's Box and so on.

What is going on in that case is that we are focused on when conduct is fraudulent and whether conduct can be fraudulent. I think the Commissioners believe it can be, and they also focused on the circumstances of the particular case and whether or not that case should go forward.

I hope that provides a little bit more context.

The CHAIRMAN. I would just add that we can tell you there is nothing new about his being very precise in his language. We remember a similar position when he was here. Probably because when he was here, precision in language stood out by contrast.

The gentleman from North Carolina.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

Chairman Cox, one of the great frustrations in dealing with corporate governance issues is the inability of shareholders to hold corporate management accountable, the inability of shareholders to elect directors who will be truly independent and will look after the interest of shareholders and not simply follow the cues of management.

That is certainly true in executive compensation, but it is true on a lot of issues.

You said in the beginning of your testimony that one of the great accomplishments of our economy is that more than half of Americans own stock now, but broker-dealers are the nominal holders of 70 to 80 percent of stock. It is in their name. It is not in the name of the person whose money paid for the stock, the beneficial owner,

and under the current law, they can vote those shares as long as they do not have in advance of a shareholder meeting specific instructions from the beneficial owner, the person whose money bought the stock. The beneficial owners never provide instructions in advance.

Shareholder democracy advocates say that creates a mismatch when there is a shareholder challenge to management like the single protestor standing in front of the tank in Tiananmen Square.

I know you answered earlier in response to Mr. Watt's questions that the SEC is now reviewing the New York Stock Exchange proposed rule that would change and no longer allow broker-dealers as nominal holders of the stock to vote in director elections.

Apparently, it changed the result in the CVS-Caremark case where advocates, shareholder democracy advocates, were trying to depose Roger Hedrick.

I have two questions. One is, do you see a problem that broker-dealers as nominal holders of stock are changing the results of important votes over what the beneficial voters voting their own stocks would have decided? Second, should it be transparent?

The shareholders who tried to depose Roger Hedrick, including pension fund managers, including the Treasurer of North Carolina, Richard Moore, had been trying to find out how the votes were cast and they had been stiff armed.

If broker-dealers as the nominal holders of stocks are voting on directors and if we pass the legislation to require a vote on executive compensation, should we be able to see how broker-dealers are voting different from those beneficial holders are voting their own interest?

Mr. COX. Apparently, you heard the response to the earlier question, so I will not go over that old ground with respect to the New York Stock Exchange proposal and so on.

To take your question or the questions in order, first, the propriety of the whole idea of broker voting. As you know, it comes about because: First, shareholders decide to hold not in their name but in street name; and second, they provide no voting instructions.

In the case particularly of mutual funds and smaller companies—by the way, this phenomenon tends to be most prominent with retail investors and they tend to be more numerous among investors in mutual funds and medium and small companies. They have special problems in reaching a quorum.

To really simplify the analogy, if you have a homeowners association and the neighbors do not send their ballots in, then you cannot ever do anything. The proxy solicitation costs go up. That is now a shareholder cost.

There are countervailing reasons that also weigh in the balance against the idea that it should be only people who own the shares and not their nominees who vote.

There is some voluntariness in the process, too, because these people, as I say, have not provided voting instructions.

The question then separately of private/secret ballot voting on the one hand or public voting on the other hand also has two edges to it. People can be very passionate—investors from all quarters, large and small—about making sure that their privacy is respected, making sure there is a secret ballot.

Other people from exactly the same quarters can make the argument just as strongly that we ought to know, particularly when somebody is purporting to vote for someone else, what they are doing. I think you have made reference to that argument well here just now.

This is all in the mix of what we are considering as we consider not only broker voting but these related questions of empty voting and under voting and over voting and so on, all of it relates to the proxy mechanism.

As we come up with new proxy rules this year, we are trying to make sure we have a good handle on all of this.

Mr. MILLER OF NORTH CAROLINA. "Maybe" is the answer to both of my questions?

Mr. COX. I think because it is a work in progress, it has to be that. That is the true and faithful answer.

The CHAIRMAN. There is a lot of interest in this and the question of third party voting and public disclosure, we took that step with the mutual funds, your successor in Congress, Mr. Campbell, has been interested in that.

I can just say now when that rule is promulgated, the combined proxy access broker voting, we will have a full hearing on that. There is a great deal of interest.

Mr. COX. We are considering all of these issues in the context of our proxy rules, and we will probably ask questions in the release when we put out our proxy rules. I do not know they will be the same rule.

The CHAIRMAN. I appreciate it. We will have a hearing and we will address it and answer your questions.

The gentleman from Georgia.

Mr. SCOTT. Thank you, Mr. Chairman.

Mr. Cox, tell me what your definition of "non-binding shareholder proposal" is.

Mr. COX. We are talking, I think, now about State law, and the question would be resolved under State law. Do the shareholders have the power under the law, the law of the jurisdiction of the company in which they have invested, to do something or not? If they do not, then the proposal is purely precatory. Otherwise, it can bind the company.

Mr. SCOTT. How do you personally feel about non-binding shareholder proposals?

Mr. COX. I am not sure I understand your question. Do I like them or not?

Mr. SCOTT. Yes. I want to try to start by getting a feel, and according to my information, at a recent Securities and Exchange Commission Proxy Roundtable meetings, there have been discussions about making amendments to your rules to restrict non-binding shareholder proposals.

That is why I want to get your understanding of them, what they are, so that we have a standard of what it is that at these proxy meetings that folks are thinking about changing and amending the rules to.

First of all, I want to make sure we get an understanding of what they are and then we can better understand why you would want to amend the rules regarding them.

Mr. COX. During this roundtable, in fact, a series of roundtables, to which you allude, we received a good deal of healthy contribution to our knowledge and understanding of precatory proposals, non-binding proposals, and shareholder resolutions in the current environment.

Many of the investor representatives whom we heard from said that this is a useful way, and these resolutions are a useful way of communicating with management. We want to make sure that we have at the SEC a healthy communication at all times between management and companies, and, indeed, we are looking for ways to enhance that.

One of the things that we talked about was the opportunity for an electronic shareholder form, whether or not more could be done with the Internet, and whether or not our proxy rules might stand in the way of any of that.

I think there is concern coming the other way that precatory proposals can be a distraction or a nuisance or sometimes can tread on the authority or the sovereignty of the directors or the executives who run the company under State law, and that tolerating them is negative. We heard a little bit of that as well.

Mr. SCOTT. Could you give me an example of that? Could you give me an example of how they would be harmful to management?

Mr. COX. I think the argument goes that management has to respond to these, that the general dichotomy in State law is that shareholders get to elect directors. They get certain financial rights, but they do not get to run the company. It is not a democracy in that sense. It is much more a republic.

When shareholders reach into responsibilities that belong under law to directors or management, there are costs and consequences that are illegitimate. I think that is the argument.

Mr. SCOTT. But they are non-binding?

Mr. COX. Yes, indeed.

Mr. SCOTT. If they are non-binding—

Mr. COX. They are non-binding and therefore there is a limit. I certainly agree with the implication of your question. There is a limit to the distraction and the costs that can be involved.

That is in any case another argument that we heard at the Roundtable.

You asked me how I feel about these things. My view is, as with everything else, we want to keep the costs down; and, in this case, we want to get all the benefit we possibly can from shareholder communication with investors. We want directors to be exceptionally attentive to the wishes of the investors because that is who elected them. Their job is to look after the company for the investors.

The more communication, the better. We are looking for cost effective ways to facilitate that that do not interfere with the running of the company.

The CHAIRMAN. A quick comment from the gentleman from Texas.

Mr. GREEN. Thank you, Mr. Chairman. Mr. Chairman, because so much has been said about lawyers today, I feel compelled to say this: This is the greatest country in the world.

One of the things that makes it great is the civil justice system, a system wherein persons will respect the rulings of courts and decisions accorded.

My suspicion is that if we could get the system that we have here, in Iraq, it would be a day of great celebration.

I do not in any way demean hedge fund managers for the enormous amount of money that they make. I do not demean CEOs who make more before noon than a minimum wage worker might make all year. I just think that the workers ought to make more. I think we ought to increase the minimum wage.

I mention this because I think that we ought to be careful how we demean this great system that we have as it relates to the role of the trial lawyer.

Having said that, I would like to talk to you very briefly about what I call pre-screening dubiety. Commissioner Campos, if I may, I would like to address you for just a moment.

You have expressed some consternation about this pre-screening process as it relates to the lawyers for the Commission having to receive some indication from the Commission as to how they should proceed with settlement negotiations.

My first question to you, Mr. Campos, is this: Do you have any tangible evidence of a public hue and cry for this new policy? Was there any public demand for a change in the policy that you are aware of?

Mr. CAMPOS. I am not aware of any public demand, but that is not something we would normally look for. The enforcement process within the SEC is something that we as a Commission and through the auspices of the Chairman and the Enforcement group have worked out systems and programs.

Mr. GREEN. Absolutely.

Mr. CAMPOS. That work well to protect—

Mr. GREEN. If I may just ask one more question, did the lawyers, the lawyers who are there involved and engaged in the process, did they ask for this change in policy?

Mr. CAMPOS. No, but again, that is not normally something that the staff would ask for.

Mr. GREEN. Is there any indication that there has been some abuse of the old policy?

Mr. CAMPOS. Again, no. You should know, and I think you do, that this is a pilot situation, and the Chairman is very well aware of the concerns that I have.

Mr. GREEN. May I ask a question about that? With this pilot, and perhaps Mr. Chairman, I would ask you this question, with the pilot program, could you give me the end date of the pilot program? When will it end?

Mr. COX. It will be permanent if it works. The pilot aspect of it indicates that we are going to be completely empirical about it and make sure it works as intended.

Mr. GREEN. With your empirical data, do you have measurements in place such that you will have an acid test to ascertain what the performance of the program is or has been?

Mr. COX. I can state clearly the objectives, and then what we will do is assess whether or not those objectives have been achieved. I

think it will be fairly clear to each of us as Commissioners and to the Enforcement staff as well.

The object is to make sure that we have clarity and consistency across a national program in implementing penalty guidance that unanimously was agreed to by the Commission relatively recently, and that, when the staff negotiate penalties, they are doing so with the wind at their back because they have the support from the Commission for what they are going to do.

The alternative, of course, is to come back to the Commission after a settlement is negotiated and hope for the best. But what that does in the private sector is put people in a situation where they are negotiating with a negotiating partner who may or may not have authority to do what they are entering into.

We are trying to make sure that finally this process moves quickly, and, if all those objectives are met, then I think the program will have achieved—

Mr. GREEN. One final question. My time is almost up. With reference to the position that you put the lawyers in, does this put them in a position such that they are strengthened or are they weakened or is this really negotiation that they are now engaged in or is it more a dictation from the Commissioners as opposed to giving the lawyers an opportunity to negotiate a settlement as opposed to one being dictated by the Commissioners who are appointed?

The CHAIRMAN. I think we can get to the answer now.

Mr. GREEN. Thank you, Mr. Chairman. I yield back.

The CHAIRMAN. We will get the answer.

Mr. COX. This is meant to strengthen the hand of the negotiators because they know they have the backing of the Commission for what they are doing. It is not meant to hamstring them or to deprive the Commission of good settlement opportunities because what generally we will be doing is authorizing a range of outcomes.

No settlement can be approved under long-standing Commission rule and practice except by vote of the Commission itself. The same is true for the instigation of litigation or even the instigation of an investigation.

In that sense, the Commission is the client and the normal communication between lawyer and client here would include at least a range of acceptable settlement outcomes.

I think this process is very consistent with all of those objectives.

The CHAIRMAN. The gentleman from Colorado.

Mr. PERLMUTTER. Thanks, Mr. Chairman. Mr. Cox, I guess in my litigation career, often we liked not to have the client's okay so we could always say to the other side, I have to go talk to my client before actually being authorized.

You might put that as one of your little points to check, does it work better for your staff having pre-authorization obviously as opposed to them having to say, I have to go to my client, I have to go to the Commission and get their authority. That is not my subject, but I am just giving you that.

Mr. COX. Just to quickly respond, I think the difference in that example that you gave is this: That might be a lawyer's tactic, but there would also be hell to pay if the lawyer went and settled the case and forgot to tell the client first.

Mr. PERLMUTTER. Right. Obviously, you want to get your client's blessing at the end of the day. I agree with you.

I did want to compliment all of you for your stamina and your fortitude. By the time you get to this, it means the panel has been sitting there for a long time. Thank you for putting up with us.

Just a couple of comments and then my main question. We have heard a little bit, whether it is Blackstone or some of the other conversations, about there does not seem to be as much activity with IPOs, etc., it is going offshore, it is going to London, this or that.

Really, what I see, and it was in the article today in the Wall Street Journal, is there is a lot of debt financing going on with respect to corporations. Obviously, that has also happened with the subprime lending market, that Wall Street has gotten involved in a big way in debt financing. It may be easier for a smaller company or whatever to be borrowing money than to be going public.

I do not know what the Commission has seen or if you have any concerns, quite frankly, about sort of this debt financing that is then participated out in a big way to various people and pensions and everything else.

Just a comment, if you would, on the debt financing that seems to be going on.

Mr. COX. As you would expect, the Commission is monitoring the impact of the subprime lending problems on CSE firms. That is our front line responsibility.

We are not a front line regulator on the other hand with respect to subprime lending generally. Our Division of Enforcement, however, is actively on the lookout for possible securities fraud involving the securitized packages of these loans. And we recently formed a working group in the Division of Enforcement to focus in specific on problems in the subprime securities market.

Mr. PERLMUTTER. I guess I would say also that would apply to the purchase of corporations, whatever they called it in this article, CLOs or collateralized loan obligations. Again, there is a lot of money out there, whether it is coming from China and Saudi Arabia and being repatriated into the United States or whatever, but a lot of money is chasing what appear to be, in some instances, lousy loans.

There will ultimately, if they are securitized, there will be a lot of work for your Commission to do, number one.

Number two, we did not talk about it very much but there is this rumor that has been circulating that the Commission is thinking about a rule to allow mandatory arbitration of what would be probably 10b-5 or fraud kinds of cases.

I would ask all of the Commissioners, and particularly you, Mr. Chairman, is that rumor true or if not—if it is, I would like to talk about it for a second.

Mr. COX. I think first the rumor got started because there was a front page story that said it was so. I had the opportunity to talk to a reporter before the story was written to say it was not the case. I have said on multiple occasions, including earlier here today, that we do not have any pending proposal to do that.

Mr. PERLMUTTER. I would like to then compliment you on your focus on seniors. I would suggest to you and recommend to you because we have had a number of panels come before us, but to also

be talking to the FTC and to the bank regulators because as we grow older, baby boomers sort of go into retirement, there is this vulnerability/susceptibility to seniors.

There is so much changing going on, whether it is technology, and we each get a different statement. You have your interactive proposal up there, a new way to share with people.

Everything keeps changing. It gets more difficult as you get older to keep up with that change. We see both on the banking side as well as really with securities lots of things changing.

I just wanted to compliment you on that. One more statement, Mr. Chairman, since I have such stamina myself.

The CHAIRMAN. Quickly.

Mr. PERLMUTTER. I wanted to talk about the third party liability or bringing in third parties. Generally, I would agree with what was said, that you do not want to bring in third parties, but there is also a dram shop kind of element, with the third party knowing there is something going on or should have known something is going on with respect to bad financial information, but still trying to turn a blind eye and going ahead and assisting.

The CHAIRMAN. The gentleman's time has expired. Now because he has been here, the gentleman from Florida. We want to try to move quickly. I will tell all the people that we are going to be held to very, very strict time standards.

The gentleman from Florida.

Mr. WEXLER. Thank you, Mr. Chairman. Thank you, Chairman Cox, and the rest of the Commissioners for being here today.

Six months ago, prior to having this great opportunity to serve in the House of Representatives for the State of Florida, I was an owner of an investment bank engaged in assisting companies raising capital.

One of the issues facing the American economy since the last market corruption is the difficulty small companies are now facing in raising venture capital.

There are several reasons for this, but one of the major contributors has been the weakness in the IPO market that has made it more difficult for venture capital to be invested in small companies because the investors in these kinds of funds are not getting the expected returns.

What we have seen is, we have seen an explosion of activity where small companies that probably should not be public have been finding ways of getting public with 15c-2-11s, reverse mergers, and they have been engaging in a transaction that the industry calls a "pipe" transaction, which is basically selling stock at a discount to investors.

Last year, and I do not have the number, but I know billions of dollars have been invested through this transaction.

The question I have is, I understand that in January, the SEC announced a re-interpretation of the Securities Act Rule 415, which limits the percentage of a company's outstanding public float that can be registered for re-sell at one time, following a private placement fund raising to 30 percent of the public float.

The problem that this has is this change, in effect, really impairs small companies' ability to raise capital, thereby endangering the

movement of billions of dollars to small entrepreneurial companies here in the United States.

What I would like to know is what is your view of Rule 415? Is anybody paying attention to what is happening to the plight of small companies here in the United States in terms of their problems and being able to raise capital, and what can the SEC do to improve the IPO market and/or change Rule 415 to encourage the movement of private equity to small companies?

Mr. COX. If I may, let me just consult quickly with the Director of the Division of Corporation Finance, who is seated right behind me.

[Pause]

The CHAIRMAN. While the gentleman is engaged, no further questions will be entertained except by those who were here, and we will move very quickly with them. If you are not here, do not come.

[Laughter]

Mr. WEXLER. Thank you, Mr. Chairman.

The CHAIRMAN. This will not come out of the gentleman's time.

Mr. COX. I want to be very precise in response to this question because we are dealing with a former investment banker. I think you will be pleased to know that our proposal that we have out will permit up to 20 percent of the public float to be used for an S–3 going forward.

There is also, I think, some concern with some kinds of PIPE transactions which are thought to be abusive, but the normal PIPE transactions would be eligible for that treatment.

Mr. WEXLER. Just to follow up, it is a big issue. The underlying problem is the fact that we do not have—our IPO market is not operating in a way that is efficiently allowing private companies to stay private, which is what they should be doing, as opposed to trying to figure out how to get public.

I would encourage you and the rest of the Commissioners to analyze what we may need to do here to encourage private equity going to small companies. It is a crisis, and we as a country need to take care of that.

I appreciate your time.

Mr. COX. I think our hearts are all in that place.

The CHAIRMAN. Thank you. We have four left. The gentleman from California, the gentleman from Connecticut, the gentleman from Missouri, and the gentlewoman from Illinois, and we are going to move very quickly.

The gentleman from California.

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

The first question is in reference to executive compensation. Last July, the SEC unanimously adopted a new executive compensation disclosure rule. In addition to requiring the disclosure of the total annual compensation for senior corporate officers and directors, the rule requires that each company file a compensation discussion and analysis.

I would like you to comment on your reaction to the first disclosure and how you would rate the usefulness of the initial CD&A filing.

Mr. COX. I have had the opportunity to personally read through several proxy statements, and what I have found is that a good deal of the new CD&A is exceptional. It is really good.

I have also read some really horrid examples. It is not just the CD&A in those cases but tends to be that the whole presentation does not have the kind of clarity that we hoped for.

Mr. BACA. What do you do in those cases?

Mr. COX. What we are trying to do is be very public in our comments. John White, who is sitting behind me, the Director of the Division of Corporation Finance, has been speaking publicly about this and engaging, as has the rest of his Division, with the private sector.

I think all of us as Commissioners have been out talking about this. We have the very best opportunity to get this right now this year.

CD&A is new. There is no boilerplate to copy. To the extent that we are trying to get away from boilerplate and we are trying to have an honest conversation between management and their shareholders, let them tell their compensation story in a meaningful way. If we start doing it that way in the first year, then we will have a lot better opportunity to do that going forward.

If we get into a rut, if we develop some bad habits, then of course, it will be a tough bell to un-ring.

We are viewing right now hundreds of companies, and we are going to make a report in the Fall and make that publicly available so that we can use some very, very good examples.

Mr. BACA. You are saying we have not gotten into bad habits yet?

Mr. COX. There has not been time yet to develop these bad habits, and we hope that we never do.

Mr. BACA. Thank you. The next question goes to all the Commissioners on the PCAOB. I think it is important that we maintain our commitment to corporate accountability and transparency. I think the independence of the PCAOB is important in that effort.

The PCAOB's members are appointed by the SEC and I commend you for working with them and addressing critical issues regarding the ongoing implementation of the Sarbanes-Oxley reform. However, I am concerned that future Commissioners could use the current oversight authority over the Board's budget, for example, to influence a decision making.

I would welcome your comments on the independence of the PCAOB and on the SEC's authority to influence the Board's decision-making process.

Mr. COX. How would you like us to proceed in terms of order here?

Mr. BACA. Whichever one you feel needs to answer the question or who you think will articulate it a little bit better, and if someone wants to articulate it a little bit differently, I would like to hear that as well.

Mr. COX. I think anyone can jump in here. I will just say that Congress has given us very explicit responsibilities under Sarbanes-Oxley. One of them is not just budget oversight of the PCAOB, but overall supervision of the PCAOB. We are taking that very, very seriously. We have developed a very collegial relation-

ship with the Board. We have a great deal of respect for the Board members and the professional staff at the PCAOB.

I think the working relationship that we have developed, if you had the PCAOB here, would be thought to be a very sound one that gives them a great deal of space in which to operate.

Our operating philosophy is that we do not wish to breathe down their necks. We want to let them do their job and supervise it. At the same time, on important things—there is nothing more important than Sarbanes-Oxley Section 404 compliance, for example—we just rolled up our sleeves and worked with them.

Mr. BACA. Micro-managing?

Mr. COX. It is really unique to 404, and, with respect to virtually everything else going forward, we have responsibilities to inspect them, for example, which we will do, but it is a supervisory relationship, and we do not want to micro-manage them. That is absolutely right.

Mr. BACA. Anyone else?

Mr. ATKINS. Yes, sir. I just wanted to add that you have to remember that under Sarbanes-Oxley, we are the people who are supposed to oversee them. They are not confirmed by the Senate. They are accountable to us. Unlike other independent agencies, they are under our supervision.

Their actions have to be approved by us, and then also people can appeal actions that they take.

Mr. BACA. Mr. Chairman, do you mind if I hear from some of the female commissioners? Because of the lateness of the hour, I did not want them to be intimidated by the males and not respond.

Mr. GREEN. [presiding] I understand that. We will now go to Mr. Murphy for 5 minutes.

Mr. MURPHY. Thank you very much, Mr. Chairman. I will be brief. I wanted to return for a moment to the issue—I know we covered it in part earlier—I wanted to just present a piece that I hope has not been covered.

I certainly join the chorus of members and members of the public who would like to see the exemptions removed. I wanted to also talk about the issue of transparency for a moment, in that right now, it is my understanding that although there are lists published of those different companies where they have short sales and failures to deliver, that right now investors and consumers are having a hard time actually getting their hands on the actual numbers of those short sales and failures to deliver.

Right now, I think they have to submit basically a Freedom of Information Request to the SEC in order to get that.

I wanted to sort of ask that general question. I know you are looking at the remaining exemptions regarding naked shorting, but I wanted to also talk about the transparency issue and to what extent you think there might be some room to talk about some greater transparency and greater ability of investors and consumers to get information related to the actual volume of short sales and failures to deliver.

Mr. COX. I am sure that you know that just a few days ago, we voted to eliminate the grandfather provision. We are trying to make sure that we actually achieve the intended results.

We are also interested in all the transparency that we can get. To the extent that is possible going forward, I think we will be in favor of that as well.

I will let Commissioner Nazareth, who has spent a good deal of time with this add to that.

Ms. NAZARETH. We are, I think, considering—I cannot remember whether we proposed it or asked it as a question, but in our deliberations just a few days ago, we discussed adding transparency with respect to the sales. We talked about having fail information made public on a delayed basis. We are very cognizant of the need for greater transparency.

Mr. MURPHY. I do appreciate your attention to that issue. I wanted to just ask a second question on a much broader basis to bring us back a little bit to the issue of fee-based versus commission-based, also some of the issues that have been discussed around some of the restrictions now regarding principal trading transactions.

It seems to me we are sort of spending a lot of time trying to work around the Exchange Act and the Advisors Act, and we are having some push back from the judicial system on some of the regulatory actions that are being attempted to try to update those two acts.

I guess as a very general question, not that this committee needs to put anything more on its plate, given the fairly large burden of work that stands before us now, but do you think it makes sense in the near future for Congress to take a look at some more general and comprehensive reform of both the Exchange Act and the Advisors Act to take into account some of the updates in the market that maybe you cannot take care of on your own?

Mr. COX. Again, being very respectful of our different roles, you have invited this comment, and I am going to make it because of the invitation.

Yes. I do think that would be an useful examination, assuming that Congress worked in its normal way. You would take the time to learn as much as you could before deciding whether or not you needed to act. I think it would be very, very healthy.

After all, these are relatively old statutory enactments, and a lot has happened in the marketplace. Things are changing. A good part of our job at the SEC is trying to use our regulatory authority to stretch onto a procrustean bed things that do not really want to be stretched like that.

Mr. MURPHY. It goes without saying that the market is very different than it was in 1934 and 1940, and although there have been updates made, it certainly seems to me it makes sense to take a look at that from a legislative standpoint.

Mr. Chairman, I yield back the balance of my time.

Mr. GREEN. The gentleman yields back. Mr. Cleaver, for 5 minutes.

Mr. CLEAVER. I will not take 5 minutes, Mr. Chairman. Thank you.

I have a hedge fund question but I need to ask Mr. Cox one question with regard to Stoneridge. Do you disagree with President Bush's decision to intervene with the Solicitor General and effectively veto your recommendation regarding your regulations?

Mr. COX. I think those who perceive this as "our decision" misunderstand a little bit the way the process works. The Solicitor General of the United States files with the Supreme Court on behalf of the United States, not on behalf of the Securities and Exchange Commission.

It is not uncommon in that process for there to be different agency views expressed for a variety of reasons, including the fact that different agencies have different charters.

Banking regulators looked at this case through a slightly different lens. Our lens is primarily investor protection. Theirs is primarily safety and soundness of the banking system. I think the SG properly takes all of these things into account.

Mr. CLEAVER. You stand with the decision that the Commission made and—

Mr. COX. Yes, given our charter and our responsibility, we were certainly within our rights to make a recommendation which we made.

Mr. CLEAVER. Hedge funds. Warren Buffet thinks that the fee schedule or the way the managers' fees are constructed is just obscene. I do, too. Somebody buys a house and then becomes a billionaire in a couple of years as a manager of these funds. That is an issue that probably needs to be dealt with at another time.

What I am concerned about is the Bear Stearns' issue from 2 weeks ago. They almost ended up and still may be very shaky as a result of the subprime market.

Are we on the verge of a cataclysm as a result of seeing some additional Bear Stearns' kinds of situations coming up with the subprime market?

Mr. COX. Let me speak first to the four corners of the Bear Stearns' issue itself. With respect to those two funds, we see little systemic risk arising from liquidity issues there.

On an ongoing basis, we are involved in the prudential supervision of all of the CSEs, the five major U.S. securities firms. We are regularly in contact with officials at these firms, and they provide us with real time reports of not only what is going on but particularly emerging financial weaknesses, if there are any.

We also, in addition to that ongoing process, are going to further review, using our SEC staff, other issues that investment managers for these funds have.

I do not believe that reporting mechanism thus far has brought us any information that would cause us to think that the circumstances you are worried about have materialized.

Mr. CLEAVER. Thank you, Mr. Chairman. I do appreciate the fact that you, God bless all of you with strong kidneys, it has been amazing.

Mr. COX. I have been nursing this one bottle of water here for about 4 hours.

Mr. GREEN. The Chair now recognizes Congresswoman Bean for 5 minutes. Thank you.

Ms. BEAN. Thank you, Mr. Chairman. I will be brief, with just some quick follow-up questions. I think we have asked you most of what we wanted to ask you. It is an honor to have you here, Chairman Cox, and all of the SEC Commissioners. We do not often have

access to your cumulative experience and intellect. We have a lot to ask.

In follow-up to when I was here earlier, Congressman Baker asked about the precedent of scheme liability. My question is, if it were to be set, do you expect to see a major increase in the amount of securities class actions?

I would address that to Chairman Cox and also to those who dissented, Commissioners Atkins and Casey.

Mr. COX. I actually do not know the answer to your question. I think it would depend a great deal upon how the court annunciated the rule, the basis for liability, and certainly from the SEC's standpoint, our thought would be that liability would be essentially what it is today. And that is for principal violators who are committing fraud.

If it is understood in that way, not as something that occurs on the margin but someone who is a primary actor, a principal violator, then that is the kind of fraud that our laws should always have encompassed.

Ms. BEAN. Thank you. Mr. Atkins?

Mr. ATKINS. Thank you. Basically, I think it is important to have a test that draws a clear line. That is why I dissented from our brief. Based on experience with what was annunciated in the Homestore.com brief, I did not think our test works. That is through experience at the SEC and then also seeing what the various Circuits came up with.

I do think, to answer your question, there is a real danger in chilling ongoing transactions. Companies will be entering into transactions up front worried about what they might be getting involved with later on, things that they have no idea about. I think that goes to the competitiveness of our economy.

Ms. BEAN. Thank you. Ms. Casey?

Ms. CASEY. I would largely agree with that as well. I think the question turns on the issue of clarity and just how clear the standard was that we put forth. I think in my view, I thought the brief before us was overly vague and broad in terms of the sweep of conduct that would be included, potentially including conduct that would normally be charged as aiding and abetting.

Again, I think it turns on clarity and that would be my answer on that. Thank you.

Ms. BEAN. Thank you. I have one other question and this is to the group, just an easy affirmative if you think so.

I know you were already asked as a Commission about the Court's order regarding broker-dealers offering fee based brokerage until October 1st. My question, and I believe you were already asked by some other members today whether you thought there was enough time for those affected entities to deal with all their customer accounts and make those proper transitions, and I believe—

The CHAIRMAN. It was asked, and it is late. Unless it is something new, let's not spend too much time.

Ms. BEAN. My follow-up question is, are any of you open to consideration of a further stay should it appear they are really not able to do that and be compliant? That is the question.

Mr. COX. We asked the Court for the amount of time that we thought we needed. I think from the Court's standpoint, they would like us to be very clear on what it is that we think we need. At this point, we think we have asked for what we need.

Ms. BEAN. Thank you. I yield back.

The CHAIRMAN. The final one, and let me say tomorrow we are going to be voting on the Appropriations bill that includes the budget, and if you were eligible for overtime, I promise you we would have taken care of you tomorrow, but we will certainly be very well disposed tomorrow if any question comes up involving your budget.

The gentlewoman from California is recognized for 3 minutes to close out the hearing.

Ms. WATERS. Thank you very much, Mr. Chairman. Thank you for your patience. I am sorry I could not be here earlier.

I just wanted to get here for a minute to say thank you to the Commissioners. This is a historic hearing and I am very pleased that the chairman organized this hearing so we have an opportunity to see all of you and very seldom, this may be the first time that I thank a panel for coming to participate, and I want to tell you why I am thanking you.

I thank you for the vote that you did on scheme liability and the vote to recommend the Solicitor General file an Amicus Curiae in support of scheme liability. I think that is extremely important.

I would just like to say that the victims of Enron and the other scandals have all but been forgotten by many people who swore to do everything they could do to help folks who had been defrauded by Enron and WorldCom and the other corporations that were involved in hiding their debt and lying about their profits or having people believe they were doing well and they were functioning properly.

It is very important that we know and understand if there is collusion between the banks and other financial institutions who know what they are doing and who understand and who are helping them to hide the lies that they are promoting.

I thank you for the vote that you have taken. I have no questions. I am very pleased that you are here.

The CHAIRMAN. I thank the gentlewoman. I will take the one last minute because I do want to comment on Stoneridge. There is one very important distinction I want to make.

I voted along, with the Chairman, for the Public Securities Litigation Act. It was the one time I voted to override the veto of Bill Clinton. I make this distinction, in that the issue was the degree of proof, the degree of argument you needed. That seems to me qualitatively different than Stoneridge where the question is what category of people are eligible.

The two seem to me distinct in this sense. In the one case we were saying, those of us who voted for the Public Securities Litigation Act, you need a certain quantum of evidence before you can make a case against anybody.

In the other situation, we were saying that no matter what evidence you have, no matter how well developed the case, these people simply are outside of it.

People could obviously come to different conclusions on both, but I did think it was important to make that conceptual distinction, and that is why, having voted for the Public Securities Litigation Act, I felt strongly that the Commission did the right thing with Stoneridge.

One is the case of insufficient evidence and the other is a case of sufficient evidence against the wrong party, except many of us do not think it was the wrong party.

I really am very grateful, and I do believe this has been a very useful hearing. It has not produced any fireworks. It has produced some rational and enlightened conversation about some important issues.

I apologize to the press, but I thank the Commission and the members.

We stand adjourned.

[Whereupon, at 5:53 p.m., the hearing was adjourned.]

A P P E N D I X

June 26, 2007

Opening Statement of Ranking Member Spencer Bachus

House Financial Services Full Committee Hearing "A Review of Investor Protection and Market Oversight with the Five Commissioners of the Securities and Exchange Commission" June 26, 2007

Thank you, Mr. Chairman, for convening this afternoon's hearing. We are here today to hear from our distinguished former colleague, Chairman Cox, and the other members of the Securities and Exchange Commission, on the important work they are doing to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.

Twenty-two months ago, Chairman Cox was sworn in as the 28th chairman of the SEC. He moved quickly to engender a spirit of cooperation and collegiality in the Commission's deliberations. Under his stewardship – and with the help of the commissioners who are here with him today – the SEC has made progress on a number of major regulatory initiatives, including the implementation of key provisions of the Sarbanes-Oxley Act; rules creating greater transparency and accountability in the area of executive compensation; and recognition of international accounting standards.

While many of us continue to be concerned about the burdens imposed on publicly traded companies by section 404 of Sarbanes-Oxley, particularly on smaller issuers, the Commission has done its best to mitigate those burdens by adopting risk-based, common-sense guidance on internal controls over financial reporting. On the enforcement side, the Commission has used its authority under the Fair Fund provisions of Sarbanes-Oxley to collect and distribute more than $1.8 billion to investors victimized by the corporate scandals of recent years.

As I have previously stated, the global competitiveness of the U.S. capital markets needs to be one of this Committee's highest priorities. Since Chairman Cox's last appearance before us, three reports have been issued by three separate blue-ribbon panels recommending a series of legislative and regulatory changes needed to maintain the competitive standing of our capital markets. It is my hope that this Committee will hold hearings to carefully examine the findings of these reports, and to consider ways in which we can eliminate inefficiencies and areas of overlap in our current financial regulatory regime.

For example, split regulatory oversight and Congressional jurisdiction over securities and futures markets makes very little sense in a 21st century economy. If we are serious about America remaining the leader in the delivery of financial services, we must encourage increased dialogue between the regulators and revisit the issue of combining the SEC and the CFTC.

During his tenure at the SEC, Chairman Cox has undertaken a number of initiatives designed to address the increasingly global nature of the capital markets, including building cooperative relationships and establishing information-sharing arrangements with the SEC's foreign counterparts. In addition to working to increase access by U.S. investors to foreign investment opportunities, the Commission has proposed eliminating the requirement that foreign companies preparing their financial statements based on international reporting standards reconcile them to U. S. Generally Accepted Accounting Principles (GAAP). This is an important first step toward the adoption of a single set of global accounting standards that could increase the attractiveness of our capital markets to foreign issuers.

Let me close by thanking Chairman Frank for convening this afternoon's hearing, and by again thanking Chairman Cox and his fellow commissioners for their work to protect investors and the integrity of our markets.

U.S. SECURITIES AND EXCHANGE COMMISSION

OVERSIGHT HEARING

BEFORE THE
COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

JUNE 26, 2007

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

Statement of the Securities and Exchange Commission
before the
House Financial Services Committee

June 26, 2007

Chairman Frank, Ranking Member Bachus and Members of the Committee:

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

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

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

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

Over the past year, a number of reports have been published which advise the SEC and Congress on how to deal with increasingly global capital markets. They have offered the Commission and policymakers in Congress and the Executive Branch many recommendations, and undoubtedly more such recommendations are on the way. While we may not individually agree with each of the recommendations and conclusions of these reports, we take seriously the detailed study that has gone into these analyses, as we do the constant and varied advice that is offered to the Commission from investors, issuers, accountants, attorneys, analysts, brokers, investment advisers, consumer advocates, and the host of financial services providers and consumers that comprise an important part of the jurisdiction of this Committee as well.

Mr. Chairman, many of the issues we face are sometimes trivialized as disputes between business and investors – as if to be pro-investor is to be anti-business, or to be pro-business is to be anti-investor. The truth is, when people invest in a company's

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

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

We have created special working groups within our Enforcement Division to deal with emerging risks such as hedge fund insider trading, stock options backdating, and microcap fraud. Earlier this year we filed the largest insider trading case against Wall Street professionals since the days of Ivan Boesky and Dennis Levine, involving major Wall Street firms as well as hedge funds. We have also devoted special attention to combating Internet fraud, through an office within the SEC focused specifically on the threats posed to investors such as email messages like, "This Stock's Ready to Explode," "Ride the Bull," and "Fast Money." Very recently, we have instituted emergency enforcement actions to suspend trading in stocks that have been the subjects of these spam campaigns. And we have instituted well over 100 investigations of options backdating, with the results of those cases now beginning to be seen.

In 1990, in the Securities Enforcement Remedies and Penny Stock Reform Act, Congress gave us the power to levy penalties against companies and individuals, along with guidance to be certain that investors were protected and not harmed by our use of this power. Throughout the 1990s, that power was used only infrequently to sanction a company. But beginning in 2002, the Commission began to use this authority more frequently. The Commissioners, our staff, and the public were in need of guidelines for decision making with respect to penalties.

After extensive study within the Commission of the legislative language, history, and purpose of the Remedies Act, the Commissioners in early 2006 voted unanimously to publish a set of principles upon which our penalty policy and practice would be based going forward. This guidance was intended to clarify for the staff and for the public the circumstances in which issuer penalties are warranted and those in which they are not. Already the Commission has imposed nearly as many issuer penalties through the first half of 2007 alone as in any full year in the Commission's history (9 cases through the first two quarters, as compared to a previous high in any calendar year of 11). Since the adoption of the guidelines, the Commission has imposed eight penalties of $25 million or

higher. No other two-year period in Commission history is higher. The second-highest SEC penalty ever imposed on a corporate issuer (Fannie Mae, $400 million) occurred after the Commission adopted its penalty guidelines. As the legislative history to the Remedies Act and our own statement on penalties make clear, the appropriateness of penalties turns principally on two considerations, the presence or absence of a direct benefit to the corporation and the degree to which the penalty will recompense or further harm injured shareholders. Thus, the size or number of issuer penalties is not an appropriate indicator of the overall success of our enforcement efforts. Our duties under the Remedies Act require us to consider the facts and circumstances of each case.

The Commission continues to work with our staff across the country to ensure that as new cases are initiated and resolved, the guidelines are being implemented as intended. To that end, the staff are beginning to present their recommendations for penalties to the Commission before negotiating penalties with the issuer.

When the Commission recovers a penalty against an issuer or an individual, our efforts do not end at the courthouse door. We are increasingly using the new authority that Congress provided us in the Sarbanes-Oxley Act to use "Fair Funds" to ensure that those dollars are returned to investors as quickly as possible. We are developing a considerable expertise in the distribution of Fair Funds, and very recently, we announced our decision to create a dedicated office that will specialize in this area. Since 2005, we have returned over $1 billion to injured investors through Fair Funds. Several additional large disbursements are pending and will be announced shortly.

All of these enforcement initiatives undergird the integrity of the U.S. capital markets and the confidence that investors can place in them. And beyond the SEC's law enforcement function, we are pursuing a number of important regulatory initiatives as well that are designed to put investors first.

With over 10,000 Baby Boomers a day turning 60 – an estimated 75 million over the next 20 years – nowhere is the need greater for the SEC's attention than in fighting fraud against older Americans. Because of the decline of defined benefit plans and the ascendancy of defined contribution plans, today's and tomorrow's seniors will need to actively manage their investments. And because they will live longer than any generation before them, many may seek a higher yield over their longer lifetimes, rather than switching into low-yield, safe investments as their parents did. Households led by people aged 40 or over already own 91% of America's net worth, and very soon, the vast majority of our nation's net worth will be in the hands of our seniors. Following the Willie Sutton principle, scam artists will swarm like locusts over this increasingly vulnerable group – because that is where the money is. And it is already occurring. Nearly every day, our agency receives letters and phone calls from seniors and their caregivers who have been targeted by fraudsters. That is why the SEC has focused its energies in this area.

Last year, the SEC organized the first-ever Seniors Summit with our fellow regulators and law enforcement officials. This year's Seniors Summit will integrate even

more of our national resources. With our partners, we are attacking the problem from all angles – from aggressive enforcement efforts, to targeted examinations and rules, to investor education. We have brought 26 enforcement actions during the past year aimed specifically at protecting elderly investors. Many of these were coordinated with state authorities. Another tool in fighting securities fraud against seniors is education. These efforts are aimed not only at seniors, but also their caregivers – as well as pre-retirement workers, who are encouraged to plan for contingencies in later life. The SEC is expanding our efforts to reach out to community organizations, and to enlist their help in educating Americans about investment fraud and abuse that is aimed at seniors. We have also devoted a portion of the SEC website specifically to senior citizens (http://www.sec.gov/investor/seniors.shtml). The site provides links to critical information on investments that are commonly marketed to seniors, and detailed warnings about common scam tactics.

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

Another of our important initiatives to benefit individual investors is our drive to improve the quality and clarity of mutual fund and 401(k) disclosure, which we have undertaken along with other departments and agencies, including the Department of Labor. Forty-seven million Americans now have 401(k) accounts through their employers, and these and other defined contribution plans now represent over $3 trillion in assets. These investments embody the hopes and aspirations of millions of Americans for a secure, decent retirement. But the disclosure that the individual investor receives about what is in the 401(k) is typically inadequate – often nothing more than one-page charts that contain extremely limited information. What is needed is clearly presented information that makes it far easier for busy Americans to understand the expenses they are being charged in connection with their investments, and the returns they are actually getting compared to an appropriate index. This sort of simplified disclosure should be readily available to every 401(k) plan participant.

Nearly half of the $3 trillion that Americans have invested through defined contribution plans is in mutual funds, so we are hard at work on a simplified, plain English disclosure for mutual funds that gives investors what they need to know, in a form they can use. We are focused on a new, streamlined disclosure document for investors that will provide better information about investment objectives, strategies, risks, and costs. Ideally, that information could be made available online, or in writing — as the investor prefers. We are also considering making information about funds and the brokers that sell them available at the point of sale.

This is not just a matter of clearer writing, but also of clarifying our regulations concerning mutual fund fees and expenses. So the Commission is conducting a thorough review of mutual fund fees and expenses, and the disclosure of these costs to investors. That review includes an examination of the $12 billion that investors now pay each year in Rule 12b-1 fees. Just last week, the Commission held a roundtable to focus on the future of Rule 12b-1.

With the same objectives in mind, the SEC has intensified its focus on "soft dollars" that brokers receive from mutual funds to pay for things other than executing brokerage transactions. Recently, the Commission acted unanimously to publish interpretive guidance that clarifies that money managers may only use soft dollars to pay for eligible brokerage and research services – and not for such extraneous expenses as membership dues, professional licensing fees, office rent, carpeting, and even entertainment and travel expenses. At the same time, we are examining the adequacy of current accounting and disclosure for soft dollars.

Nothing holds more promise for giving ordinary investors the information they need in a timely, useful way than interactive data. New technology that can sort through mountains of SEC-mandated disclosure and turn it into something meaningful holds enormous potential for investors. What we are calling "interactive data" will provide investors in mutual funds, 401(k)s, common stocks and other securities far more useful information than anything they have ever gotten from the SEC before.

For years, ordinary investors have been stymied by the way that supposedly public information is made so inaccessible to them. It simply takes too much time and effort to separately look up each SEC filing for every single company or fund they might own or be interested in owning. Locating the information often requires knowing the name and date of a particular SEC form. Even once the right forms are located, wading through all of the legal jargon to find the right numbers has been nearly impossible for the average investor.

Technology can help here. The SEC's current online system, known as EDGAR, is really just a vast electronic filing cabinet that does little to exploit the power of today's computers. Sure, it can bring up electronic copies of pieces of paper on your computer screen, but it does not allow you to manage that information in ways that investors commonly need. Interactive data would change that. It would allow any investor to quickly find, for example, the mutual funds with the lowest expense ratios, the companies within an industry that have the highest net income, or the overall trend in their favorite companies' earnings.

It works by giving each piece of information in a disclosure document a unique label, written in an internationally used computer language called XBRL. The Commission is investing more than $54 million over several years to build the infrastructure to support widespread adoption of interactive data. Companies have told us that the substantial benefits of implementing XBRL will exceed the minimal costs. In addition to providing far more useful information to investors, we believe the use of

interactive data can make companies' internal processes more efficient, saving investors' dollars for the costs of registration and compliance reporting to the SEC. It will also make the SEC's own disclosure reviews more productive.

And to insure that shareholders have the opportunity to exploit this new informational power in SEC filings such as proxy statements, the Commission is updating our rules to permit the use of the Internet to improve communications between companies and their shareholders. For example, our recently adopted e-proxy rules will allow shareholders to choose whether to access their proxy materials in paper or electronically. Of course, shareholders who prefer to receive their proxy materials on paper will always be able to do so – and even then they will still have the opportunity to use the proxy materials on the Internet as well. When it comes to interactive data, the shareholders are in the driver's seat.

In connection with the Commission's review of our proxy rules governing shareholder proposals, we have just completed a series of roundtables that considered, among other issues, the future role of technology in facilitating communications not only between shareholders and their company, but also directly among shareholders themselves. As we prepare to put new proxy rules in place in time for the next proxy season to address the implications of the court's decision in AFSCME v. AIG, the Commission is also considering ways to facilitate greater online interaction among shareholders by removing any obstacles in the current rules, such as the ambiguity concerning whether use of an electronic shareholder forum could constitute a proxy solicitation.

Interactive data will soon enable mutual fund owners to make instant comparisons of the "risk/return summary" provided by each fund. Just last week, the Commission voted to allow mutual funds to file this key investor information on risks and returns in interactive data format, which we expect will soon lead to an increasing number of funds offering investors this new capability.

From our vantage point at the SEC, it is also clear that interactive data will significantly improve audit quality. Our Office of the Chief Accountant has reported that a significant percentage of recent public company restatements were due to misapplying basic accounting rules, rather than deliberate errors or fraud. So there is an enormous opportunity for automation to help corporate finance staffs and auditors avoid simply missing things — and to avoid the kinds of unintentional mistakes that can have big consequences.

Interactive data will soon showcase its potential to help investors in yet another area: the disclosure of executive compensation under the Commission's new rules. The new executive compensation disclosure marks a sea change. Now, instead of bits and pieces of compensation information scattered about the proxy statement, buried in footnotes, or not really clearly disclosed at all, there is one number that clearly totals all compensation from all sources. And that number is clearly broken down into its parts, so that anyone who wants to compute the totals differently can do so. That is where

interactive data comes in. Once all companies report their executive compensation information using interactive data, it will be a cinch to reconfigure the numbers any way one pleases, and to make instant comparisons across companies and across industries.

To demonstrate the power of interactive data to make the investor's job easier, the SEC itself is tagging the 2007 executive compensation information for all of the S&P 500 with XBRL labels. We will soon be posting a set of easy to use interactive data software tools on our website that will make the executive pay data interactive. Beyond performing calculations and comparisons online, anyone will be able to download the information directly into an Excel spreadsheet or other software program of their choice. Here is a brief example of how this will work.

It is important to recognize that interactive data is not just a way to improve the usefulness of SEC-mandated disclosures here in the United States – it is a truly international standard being developed in over 100 countries that will revolutionize the way financial information is exchanged across our planet. That is why the SEC is committed to doing everything in our power to ensure that XBRL remains an international, stateless, and open source standard. All of the XBRL software development that we do, and that we support, is open source. It is being contributed to the global effort to eliminate friction in the exchange of financial information, so that company data can travel at the speed of light, 24/7, with built-in automated quality control.

Technology is not only helping ordinary investors to make sense of information coming increasingly from around the world, but it is driving the rapidly accelerating globalization of capital markets. We are confronting the challenges and opportunities of more foreign listings here in the United States in a number of ways, not least of which is the growing prevalence of IFRS, or International Financial Reporting Standards. The SEC now reviews IFRS financial statements from foreign issuers, as well as U.S. GAAP statements from domestic issuers. Last week, the Commission proposed to eliminate the U.S. GAAP reconciliation requirement for foreign private issuers that file using IFRS as published by the International Accounting Standards Board. We also have been supportive of the international effort to develop a set of standards that is high-quality, comprehensive, and rigorously applied, because of the significant potential benefit of converging these two standards. A truly global set of standards would allow investors to draw better comparisons among investment options. It would also lower costs for investors and issuers, who would no longer have to incur the cost of maintaining and interpreting financial statements using different sets of accounting standards.

Of equal importance here and in the rest of the world is rationalizing the implementation of the Sarbanes-Oxley Act ("SOX"). The SEC has just finalized new guidance for management in implementing section 404 of the Act, and the PCAOB has issued a completely new auditing standard to streamline and improve the audit of a company's internal controls. The new standard, if the SEC approves it, and the new guidance should permit audit committee members to focus on the material risks that investors care about. This represents over two years of work towards improving the implementation of 404 for all companies.

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

When, eventually, smaller companies do come into full compliance in 2009, the new auditing standard will allow them to tailor their compliance efforts to their own individual facts and circumstances. The new standard encourages the scaling of all audits. Small companies will be able to apply the guidance to their unique control systems – rather than create costly or complex control systems for the sole purpose of complying with the guidance. By tailoring the documentation and evaluation approaches to their particular business, we hope to avoid the one-size-fits-all, check-list approach that many larger companies have bristled under as they have tried to comply with 404.

With new guidance that allows management to scale and tailor evaluations – the better to focus on what matters most – and a significantly improved standard that should enable auditors to deliver more cost-effective audit services, one important step remains. The SEC and the PCAOB expect a change in the behavior of the individuals who are responsible for following these new procedures. To that end, the PCAOB's inspection program will monitor whether audit firms are implementing the new auditing standard in a way that is designed to achieve the intended results. And the SEC, in our oversight capacity, will monitor the effectiveness of the PCAOB's inspections. So both the SEC's and the PCAOB's inspectors will be focused on whether audit firms are achieving the desired efficiencies in the implementation of 404.

These improvements to Sarbanes-Oxley are important in the international realm, because while many countries (including the United Kingdom) have adopted requirements similar to our internal control assessment in section 404(a) of SOX, ours is the only country that requires an independent auditor's report and attestation on those controls – and that fact has been a source of friction not only with other markets but with other national regulators and international bodies. The Congress has charged the SEC with making 404 work both effectively and efficiently, and we recognize that doing so will greatly benefit U.S. investors as well as the competitiveness of U.S. companies and financial services providers in the global capital markets.

As our markets continue to converge across national boundaries, issues such as cross-border fraud are driving national regulators to work together as never before. We all understand that we cannot go it alone, if ever we could before. And as the SEC works with our counterparts overseas, we are increasingly finding that in many areas our regulatory objectives are very much the same. We are currently exploring whether in some cases, convergence and harmonization is the right approach; whether in other cases, an intentionally different national approach is best; and whether sometimes, simply offering investors a choice after full disclosure might be the way to go. The current efforts to converge U.S. GAAP and IFRS represent an example of the first approach; our insistence on a high level of national securities market enforcement represents the second; and our current consideration of the possibility of selective mutual recognition of other regulatory regimes represents the third approach. These are all tools in our toolkit as we work together with our counterpart regulators in other countries.

Yet another area in which U.S. regulation is being updated to deal with the environment in international financial services is the entry of banks into the securities business. The Gramm-Leach-Bliley Act was a significant step forward in recognizing the changing landscape of the financial markets, including by lowering the barriers between the banking and securities industries that had been erected in the early 1930s. Today, the Commission is engaged with the Federal Reserve Board and other banking regulators to implement the specific provisions of Gramm-Leach-Bliley that sought to rationalize the web of regulation governing when banks need to register with the SEC as brokers. We expect that the final rules interpreting the bank-broker exceptions of Gramm-Leach-Bliley will be completed early this fall.

No discussion of the work the SEC is doing in international financial markets would be complete without reference to our role as the consolidated supervisor for the country's largest investment banks. When the European Union issued its Financial Conglomerates Directive, which essentially requires non-EU financial institutions doing business in Europe to be supervised on a consolidated basis, the Commission in 2004 crafted a new comprehensive consolidated supervision regime that was intended to oversee the holding companies and material affiliates of major broker-dealers. The rule is designed to address the Commission's concern, in our role as the functional regulator of U.S. broker-dealers, that a broker-dealer could fail due to the insolvency of its holding company or an affiliate. This risk, exemplified by the bankruptcy of the Drexel Burnham Lambert Group and the consequent liquidation of its broker-dealer affiliate in 1990, has become more salient as broker-dealers have affiliated within ever-more complex holding company structures.

The Commission's CSE program for group-wide risk monitoring of firms with a large and well-capitalized broker-dealer has five principal components. First, CSE holding companies are required to maintain and document a system of internal controls that must be approved by the Commission at the time of their initial application. Second, before approval and on an ongoing basis, the Commission examines the implementation of these controls. Third, CSEs are also monitored continuously for financial and operational weakness that might place regulated entities within the group or the broader

financial system at risk. Fourth, CSEs are required to compute a capital adequacy measure at the holding company that is consistent with the International Convergence of Capital Measurement and Capital Standards of the Basle Committee on Banking Supervision. Finally, CSEs are required to maintain significant pools of liquidity at the holding company, where these are available for use in any regulated or unregulated entity within the group without regulatory restriction. This program enables the Commission to monitor these major securities firms, which is of growing importance given their possible systemic implications.

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

Since we have the opportunity to appear before you today as a full Commission, let me offer a word about the way we function as a body. This particular group of Commissioners has worked hard together to achieve our common goals of investor protection, efficient markets, and healthy capital formation. During Chairman Cox's tenure as Chairman, 98% of the Commission's decisions have been the result of a unanimous vote of the Commissioners. That is not because the issues just described are easy, or because we always agree. Rather, it is because the capital markets of the United States – and now, the world – depend upon clarity and consistency in our regulatory and enforcement programs. The agency's non-partisanship has underscored that it is the rule of law, not one's political point of view, that should determine our actions. It is in this spirit that we intend to continue to tackle the significant challenges that lie ahead.

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

A Review of Investor Protection and Market Oversight with the
Five Commissioners of the Securities and Exchange Commission

Committee on Financial Services

U.S. House of Representatives

June 26, 2007

Questions Submitted by Chairman Frank

Market Regulation

There are a number of market data filings, including exchange rule filings, that have been pending with the staff or the Commission for some time. In response to questioning concerning the timing of Commission action on these items, you stated that review of these matters is ongoing and would take months. Please explain with specificity why the process for taking action on the pending rule filings is so lengthy, when the staff and the Commission intend to take action on the backlog of filings and how the Commission plans to streamline and expedite the approval process for rule filings going forward.

ANSWER:

The Commission currently is reviewing a broad range of market data issues raised by the filings pending with the Commission or the Commission's staff. In November 2006, the NetCoalition, a public policy voice for certain Internet companies and securities firms, petitioned the Commission to review an order, issued by the Commission pursuant to delegated authority, approving a proposed rule change filed by NYSE Arca, Inc.[1] The proposal sought to establish fees for the receipt and use of certain market data that consists primarily of a compilation of all orders resident in the NYSE Arca limit order book. This type of information is commonly referred to as "depth-of-book" order data. In December 2006, the Commission issued an order granting NetCoalition's petition and allowing any party or other person to file a statement in support of or in opposition to the action made by delegated authority.[2]

Commenters submitted statements sharply disagreeing on whether the specific NYSE Arca proposal should be approved, as well as on a variety of broader market data issues. These issues include, for example: (1) the level of fees for "core" data that is required to be consolidated and distributed by a central processor pursuant to joint-industry plans, as well as the use of those fees in funding the self-regulatory organizations ("SROs"); (2) the quality of the consolidated core data feeds, including their speed and content, when

---

1 Securities Exchange Act Release No. 54597 (October 12, 2006), 71 FR 62029 (October 20, 2006).

2 In the Matter of NetCoalition, Securities Exchange Act Release No. 55011 (December 27, 2006) (order granting petition for review and scheduling filing of statements).

compared with the quality of non-core data feeds distributed by individual exchanges and market participants; (3) the conversion of many exchanges from membership organizations to for-profit public companies and the effects of this change on market data products and fees; (4) whether the increasing importance to data users of non-core, depth-of-book order data requires a change in the regulatory treatment of such data; (5) whether the total of all fees from depth-of-book data products distributed by the various markets has reached, or is likely to reach, an unreasonably high level; and (6) whether the SROs and joint-industry plans should provide greater public disclosure concerning their market data revenues and costs. In addition, a number of proposed rule changes submitted by SROs other than NYSE Arca present the same or analogous market data issues.

Given the importance and complexity of the issues raised in the NetCoalition matter and by other SRO market data proposals, the Commission is proceeding in a deliberate fashion to reach considered decisions supported by substantial facts and analysis. These decisions will need to reflect multiple objectives of the Securities Exchange Act of 1934 ("Exchange Act"), including: (1) assuring high quality information for investors that enables them to obtain best execution of their orders and otherwise achieve their trading and investment objectives; and (2) promoting fair competition among broker-dealers, exchange markets, and markets other than exchange markets. The Commissioners and staff have focused intensely on market data issues in light of all the comments received and we anticipate that the Commission will consider the NetCoalition matter within the next few months.

The Commissioners recognize the pressing need for action on all pending SRO market data proposals. The U.S. equity exchanges operate in an intensely competitive environment. They need certainty and finality concerning their rule proposals and applicable regulatory requirements so that they can adjust their business strategies accordingly. With respect to the processing of SRO rule filings in general, the Commission continues to evaluate the rule filing process mandated by the Exchange Act in response to constantly changing technology, recently-adopted automated and hybrid trading systems, and overall changes to our market structure, to ensure that SRO rule proposals are processed efficiently and expeditiously.

The Exchange Act specifies that a proposed rule change may not take effect unless it is noticed for public comment and thereafter approved by the Commission, or is otherwise permitted to become immediately effective under Section 19(b). A proposal that is published by the Commission for public comment should be complete and clearly described, because a vague and incomplete proposal would be unlikely to elicit meaningful public comment. To the extent that an SRO's filing does not accurately describe its proposal or raises concerns under the federal securities laws, delays may be encountered when it becomes necessary for the SRO to prepare and file an amendment to its proposal to clarify the operation of its proposal or to further revise proposed rule text. Additionally, the Commission's ability to make the findings required to approve a proposal as consistent with the Exchange Act and all applicable rules and regulations is dependent upon the completeness of the SRO's proposal that details its proposed rule change. Therefore, SROs can expedite the approval process by ensuring that their

proposed rule changes are thoroughly described, adequately analyzed, and clearly presented.

For those proposals that are required to be acted on by the Commission, the Exchange Act generally requires the Commission to act within 35 days of the date of publication of the notice of the proposal. However, delays may arise when the Commission receives numerous substantive comments on a proposal, since both the Commission and the SRO must thoroughly consider the comments and address the commenters' concerns, as appropriate.

Certain types of proposed rule changes may become effective immediately upon filing with the Commission or within 30-days in the case of certain non-controversial proposals. The "non-controversial" category of immediately effective proposals addresses those proposals that do not significantly affect the protection of investors and do not impose any significant burden on competition. Such proposals are less likely to engender adverse comments from interested parties or require the degree of review necessitated by more significant proposals. For example, subsequent modifications to an SRO's electronic trading system that do not significantly alter the exchange's market structure or introduce anti-competitive or unfairly discriminatory aspects to its operation may be eligible for immediate effectiveness. In particular, immediate effectiveness of these types of modifications to SRO trading systems allows SROs to more quickly respond to competitive pressures from non-SRO competitors.

The ability of SROs to designate a proposed rule change for immediate effectiveness in compliance with Rule 19b-4 represents the most direct way in which exchanges can expedite their proposed rule changes. Approximately half of the proposed rule changes submitted by SROs in 2005 and 2006 were designated for immediate effectiveness. As SROs increasingly utilize the availability of immediately effective filings, it should proportionately reduce the number of filings that must be acted on by the Commission, thereby allowing the Commission to devote more attention to those filings that raise novel issues or warrant closer regulatory scrutiny.

The Commission staff endeavors to process SRO rule proposals in an efficient manner. Recent funding increases have allowed the Commission to increase staff, which has helped in the processing of increasing numbers of SRO rule filings. Further, the Commission continues to explore ways to improve the rule filing process in a manner that is consistent with its mandate in the Exchange Act in order to meet the changing needs of the exchanges in a competitive financial marketplace, while at the same time maintaining appropriate Commission oversight of the SRO rule-making process to ensure continued protection of investors and the public interest.

Mandatory Shareholder Arbitration

With respect to mandatory shareholder arbitration for securities fraud actions, please clarify whether under current procedures a registration statement containing a covenant or provision mandating arbitration could be declared effective or allowed to go effective.

Similarly, please clarify how a proxy statement containing a proposal for shareholders to vote on such a provision would be processed.

ANSWER:

When an issuer of securities has included a mandatory shareholder arbitration provision, including those relating to securities fraud actions, in its articles of incorporation or its by-laws and files a registration statement, the Division of Corporation Finance staff may make comments seeking full disclosure about the implications of those provisions with respect to the interests of shareholders or any other implications. When an issuer has included a proposal for a shareholder vote on such a provision in its preliminary proxy statement, the Division of Corporation Finance staff may make similar comments.

If an issuer with such a provision sought acceleration of the effective date of a registration statement, the Division of Corporation Finance would determine whether its comments had been satisfactorily addressed and, if so, pursuant to delegated authority, would allow the registration statement to become effective.

Short-Selling

Understanding that revisions to Regulation SHO have just been adopted, and still others have been recently proposed, what information can you provide on whether Regulation SHO has been effective in curbing abusive short-selling practices and in reducing failures to deliver.

QUESTION: Have any formal enforcement actions been taken relating to violations of the regulation?

ANSWER:

To date, there have been no Commission enforcement actions announced involving Regulation SHO. However, the New York Stock Exchange ("NYSE") has brought four enforcement actions involving violations of Regulation SHO.

In June 2006, NYSE Regulation, Inc. censured and fined Daiwa Securities America Inc., Goldman Sachs Execution & Clearing, L.P., Citigroup Global Markets, Inc., and Credit Suisse Securities (USA) LLC, each a member firm, for operational deficiencies and supervisory violations concerning Regulation SHO. These cases resulted in fines ranging from $250,000 to $400,000 for a total of $1.25 million.

In July 2007, the American Stock Exchange fined two options market makers for violations of Regulation SHO. SBA Trading was sanctioned $5 million and ALA Trading was sanctioned $3 million including disgorgement for misusing an exception to Regulation SHO to facilitate impermissible short selling.

In comparing a period prior to the effectiveness of the current rule (April 1, 2004 to December 31, 2004) to a period following the effective date of the current rule (January 1, 2005 to May 31, 2007) for all stocks with aggregate fails to deliver of 10,000 shares or more as reported by NSCC:

- The average daily aggregate fails to deliver declined by 27.0% after the effective date of Regulation SHO.
- The average daily number of fail to deliver positions declined by 14.0%.
- The average daily number of threshold securities declined by 38.0%. (The average daily number of threshold securities declined by 14.9% since January 2005.)
- The average daily fails of threshold securities declined by 50.8 %.
- A total of 11,345 securities "graduated" from the threshold list since January 10, 2005 representing 8.2 billion shares in fails.

QUESTION: What have you learned through OCIE and NASD inspections about changes in practices since adoption of the rule?

ANSWER:

Staff of the Office of Compliance Inspections and Examinations ("OCIE"), the NYSE and NASD Inc. ("NASD") conducted coordinated examinations of clearing firms that execute and clear short sale transactions. The purpose of the examinations was to evaluate whether firms were in compliance with the provisions of new Regulation SHO under the Securities Exchange Act of 1934. Staff found that the industry has taken significant steps to comply with the requirements of Regulation SHO, including significant corrective action in response to staff findings. Staff also identified areas in which further rule making may be necessary in order for the rule to be more effective. For example, staff identified the grandfather exception and the options market maker exception as areas that may warrant further consideration to promote closing of fail to deliver positions.[3] Below is a summary of some of the findings from Staff's review, as well as corrective actions taken by firms in order to be in compliance with the Rule.

---

[3] On June 13, 2007, the Securities and Exchange Commission approved adoption of amendments to eliminate the grandfather provision in Rule 203(b)(3)(i) so that all fail to deliver positions in threshold securities will have to be closed out within 13 consecutive settlement days, regardless of whether they occurred before the security became a threshold security. The amendment will be effective 60 days from publication in the Federal Register. On June 13, 2007, the Securities and Exchange Commission voted to re-propose amendments to eliminate the options market maker exception to the close-out requirement of Regulation SHO. The options market maker exception provides that any fail to deliver position in a threshold security resulting from short sales effected by a registered options market maker to establish or maintain a hedge on options positions that were created before the underlying security became a threshold security did not have to be closed out.

Commission/SRO Sweep Examinations

Along with the SROs, we conducted 19 exams finding mixed compliance. In that this was a new rule, many firms lacked adequate procedures to ensure compliance. The most serious finding by the staff was that most firms examined by the staff did not have adequate written supervisory procedures to ensure compliance with the Rule. Other staff findings included: some firms incorrectly marking orders; firms not performing locates prior to the execution of a short sale; and firms not closing out fail to deliver positions within 13 consecutive settlement days (however the number of instances found was quite small).

Corrective actions adopted by firms as a result of the sweep examinations included: firms implementing enhanced procedures to: detect instances of orders that were not appropriately marked; adequately document locates prior to the execution of a short sale; determine instances of transactions that resulted in fails to deliver and to detect any patterns of abuse; adequately age fails to deliver so that fail to deliver positions could be adequately closed; and not allow short sale executions in securities that had fail to deliver positions outstanding more than 13 consecutive settlement days.

Other Sweep Examinations

Subsequent to the Reg SHO Sweep, OCIE conducted 15 additional examinations where compliance with Regulation SHO was part of the examination focus. Some of the staff findings from these examinations included the following: firms failed to conduct and document locates prior to executing short sale transactions in several hard to borrow securities and firms failed to establish and enforce written supervisory policies with respect to Reg SHO.

Corrective actions adopted by these firms included: firms enhanced procedures to require that supervisory approval be granted prior to executing short sale transactions in hard to borrow securities and firms established written supervisory policies to document locates.

The options exchanges are conducting options market making examinations for compliance with Regulation SHO. The examinations are on-going.

QUESTION: How are OCIE and the NASD enforcing the regulation and have any informal actions been taken relating to violations of the regulation?

ANSWER:

As noted above OCIE, NYSE, and NASD have conducted coordinated examinations of firms' compliance with Reg SHO. Examinations indicating serious violations were referred to SRO enforcement staff. Some specific enforcement and regulatory actions are summarized below.

NYSE

The NYSE levied fines of $1.25 million in the aggregate against the four firms (from the coordinated sweep) for Regulation SHO violations, including supervisory deficiencies, failure to obtain locates and failure to ascertain that orders were properly marked. The NYSE also conducted some special Reg SHO exams concerning significant fails in a particular security. It reviewed four firms and found some deficiencies with firm policies and procedures, as well as locates without adequate justification.

NYSE has also built an internal system to monitor fails at all member organizations on an ongoing basis and inquires of firms as to the reason why the fails to deliver existed. Most firms have responded that the fails were permissible as they fell within the grandfather or options market maker exception.

On January 10, 2007, NYSE enforcement initiated ongoing investigations regarding Reg SHO. The NYSE reviewed securities on the NYSE threshold list using certain criteria and selected 20 securities and inquired of certain firms the basis of their net fail to deliver positions at CNS. The NYSE is still gathering information from firms and the review is ongoing.

The NYSE had four closed enforcement cases (decided by a hearing panel) concerning Reg SHO for failure to locate securities prior to effecting short sales, inadequate policies and procedures to ensure compliance with Reg SHO and incorrectly marking orders "long" when they were sold short. Firm fines ranged from $60,000 to $2 million for securities violations that included Reg SHO violations.

NASD

On January 1, 2006 NASD initiated a sweep of 19 firms focusing on Reg SHO elements. NASD cited 4 firms for incorrectly marking long sales when the firm was not long the security, not performing locates, and having inadequate procedures (particularly concerning close-out requirements). The NASD has also conducted quarterly sweeps to evaluate firm compliance with the close-out provision of Reg SHO. Using certain criteria (*i.e.*, duration of the fail to deliver) NASD sent letters to some firms requesting information about the basis for the fails to deliver and what steps the firms were taking to close-out the fails.

NASD concluded four enforcement matters for Reg SHO violations. These matters were all Acceptance Waiver and Consent settlements with fines ranging from $12,500 to $40,000 for failure to close-out fails to deliver and supervisory deficiencies.

OCIE

As noted in the previous answer, in response to examination sweeps undertaken by OCIE NYSE, and NASD, firms have taken a variety of corrective actions including, for example, enhancing procedures to require supervisory approval be granted prior to

executing short sale transactions in hard to borrow securities and establishment of written supervisory policies to document locates.

QUESTION: What else can be done to deter manipulation in smaller stocks or other abusive practices?

ANSWER:

A well targeted enforcement program is critical to address manipulation and other abusive practices involving small stocks. To build on our ongoing efforts, the Commission is currently in the process of forming a specialized "microcap" fraud unit within the Enforcement Division. This unit will work closely with all of the Commission's Divisions and Offices to focus on abusive practices in the microcap markets.

The Commission will also continue to promulgate or amend rules, as needed, to combat fraud. For example, on June 20, 2007, the Commission approved amendments to make Rule 105 of Regulation M more effective. Prior to the amendments, Rule 105 prohibited a person from covering a short sale with securities sold in an offering, if such person sold short within five days prior to pricing or the period beginning with the filing of the registration statement and ending with pricing, whichever is shorter. During the past few years, however, the Commission brought a number of enforcement cases in which persons attempted to conceal their violative activity and evade Rule 105. As a result, the Commission adopted an amendment to Rule 105 to make it unlawful for a person to effect a short sale during the Rule 105 restricted period and purchase such security in an offering.

QUESTION: To what extent should disclosure be made to investors if a broker-dealer does not hold sufficient shares to cover a position? Should shareholders be made aware of the impact failures to deliver have on the proxy process?

ANSWER:

For some background, it may be helpful to put naked short selling and the magnitude of fails to deliver in some perspective. Approximately 99% (by dollar value) of securities transactions settle on time (T+3). Of those not settling on time, 82% will be closed out within 5 days (*i.e.*, 2 days after settlement day), 87% will be closed out within 6 to 10 days (*i.e.*, 3 to 7 days after settlement day), 97% will be closed out within 30 days, and less than 1% will remain open after 200 days. It is also important to remember that fails associated with abusive short selling represent only a small percentage of total fails.

Broker-dealers frequently have unavoidable imbalances between the aggregate number of securities they have credited to their customers' accounts versus the number of shares they have on deposit in their accounts at the Depository Trust & Clearing Corporation. Fails-to-deliver are only a relatively small cause of any such imbalances. Securities

lending, which is an integral and vital component of the U.S. securities markets, is likely a more significant cause of any imbalance.

In an effort to find an appropriate regulatory solution to, among other things, situations where broker-dealers have an insufficient number of shares for customer proxy voting, the Commission held a series of roundtables in May 2007 to discuss the issues related to proxy distribution and voting. Issuers, broker-dealers, transfer agents, banks, institutional investors, and proxy service providers provided their views and opinions on the current proxy process and on various industry proposals intended to improve the proxy process.

The Commission is currently considering the appropriate regulatory response to various proxy-related issues, including those related to over- and under-voting. Because the manner in which securities are traded and then settled in the U.S. raises a number of challenges in the proxy distribution and voting process, we have to carefully balance the operational functioning of the U.S. securities markets (which are the most liquid, most efficient, and safest in the world) with the goal of enabling beneficial owners to vote their shares. Our preliminary research indicates that approximately 35% of retail investors vote while approximately 95% of institutional investors vote. Our preliminary research also indicates that an imbalance occurs in less than 1 percent of elections. The actions under consideration at this time include, but are not limited to, revision of Schedules BD and 13G to better describe securities lending and other activities by 5% holders which lead to overvoting, required disclosure by broker-dealers of their policies and procedures related to the allocation of votes among customers, required disclosure by broker-dealers of how customers may better ensure their right to vote, and broker-dealer reporting obligations related to under- or over-voting.

Soft Dollars

Does the Commission plan to implement the recommendations of the Task Force on Soft Dollars regarding improved transparency to investors of soft dollar payments through disclosure or otherwise? What is your anticipated time-frame for further action?

ANSWER:

We are in the process of studying alternative approaches to improving transparency to investors of soft dollar payments. Our goal is to help investors get the information they need, in a form they can really use and understand. The staff is working on identifying and assessing different approaches that we could propose within a reasonable time.

Also, just last year, we issued guidance intended to clarify the boundaries of what might qualify as "brokerage" or "research" services that are eligible for the statutory safe harbor under section 28(e) of the Exchange Act. That section, which was written over 30 years ago to address very different market conditions than we face today, has proven difficult to administer. That's why, as you know, Chairman Cox has asked Congress to consider legislation to repeal or substantially revise that section.

Preemption of State Laws

NASD Rule 2130 requires that, prior to expungement of information concerning an NASD arbitration from the Central Registration Depository system, a court of competent jurisdiction must order that action or confirm the arbitration award containing the expungement relief. If state law prohibits expungement and a state court of competent jurisdiction on the basis of state law will not order expungement or confirm an arbitration award granting such relief, what are the Commission's views on whether the NASD rule would preempt state law?

ANSWER:

NASD Rule 2130 governs expungement of information from the Central Registration Depository (CRD). Specifically, the rule governs expungement in connection with information in CRD arising from disputes with customers. The rule requires a member or associated person to obtain an order from a court of competent jurisdiction directing expungement of the information or an order from a court of competent jurisdiction confirming an arbitration award containing expungement relief. The rule requires that the NASD be named as a party in all expungement cases. Furthermore, the rule sets forth the findings that the NASD will review in connection with any expungement request to a court. Specifically, the NASD will review to determine whether the expungement relief is based on affirmative judicial or arbitral findings that:

1. The claim, allegation or information is factually impossible or clearly erroneous;
2. The registered person was not involved in the alleged investment-related sales practice violation, forgery, theft misappropriation, or conversion of funds; or
3. The claim, allegation, or information is false.

If there was no such finding, but the NASD believes that the expungement relief and findings are meritorious and would have no material adverse effect on investor protection, the integrity of CRD, or regulatory requirements, it can allow the expungement relief to proceed even though it is not based on the enumerated findings.

The rule was adopted after an agreed upon moratorium on expungements. It was meant to add safeguards to the expungement process. The states and the NASD were concerned that arbitrators were ordering expungement without specific authority setting forth situations in which expungements might be granted.

Questions Submitted by Mr. Kanjorski

Market Regulation

In response to market demands and recent regulatory reforms, U.S. exchanges have worked to modernize their operations. In pursuing these changes, these exchanges also often must negotiate and obtain approval from the U.S. Securities and Exchange Commission (SEC) for changes in their underlying self-regulatory organization (SRO) rules. It can take months or even years to complete the SRO rule change review process at the SEC. Domestic futures markets, ECNs and the competitors of U.S. exchanges in other nations do not necessarily face such procedural hurdles in order to change their rules and operations.

One specific example regarding these matters concerns the adoption of SRO rule changes to enable specialists at the New York Stock Exchange to operate more effectively within the new regime mandated by the rule on National Market Structure, otherwise known as Regulation NMS. The SEC is now considering rule changes to update the parameters under which a specialist may trade in light of Regulation NMS. What is the status of approving these changes?

What steps could the SEC take to ensure that this application and other SRO rule amendment filings by other exchanges move expeditiously through the SEC's review process? Some have proposed a "prudential" approach to streamline the SRO rule approval process. Under such a system, SROs would have a clear set of standards to follow and a flexible implementation methodology to meet those standards. Could this system address the shortfalls of the present approval process and still protect investors? What regulatory or statutory changes would be needed to pursue such a reform?

ANSWER:

As you indicate, national securities exchanges are subject to various requirements under the Securities Exchange Act ("Exchange Act"), including the requirement in Section 19(b) and Rule 19b-4 thereunder to file their proposed rule changes with the Commission, which are published for notice and comment. A proposed rule change may not take effect unless it is thereafter approved by the Commission or is otherwise permitted to become effective under Section 19(b) of the Exchange Act. By providing for Commission review of proposed rule changes and allowing for public notice and comment from interested parties, this requirement is designed to ensure that each exchange carries out the purposes of the Exchange Act and exercises its regulatory authority appropriately. Any changes to the fundamental principles underlying the current SRO rule filing process would require an amendment to the Exchange Act, as well as corresponding amendments by the Commission to the applicable rules and regulations thereunder. Nevertheless, we recognize that, as with most things, there is always room for improvement and we are open to considering improvements that would not require a legislative component.

For those proposals that are required to be approved by the Commission, the Exchange Act specifies the standards and time periods for Commission action, generally requiring the Commission to act within 35 days of the date of publication of the notice of the proposal, though the Commission may approve a proposed rule change on an accelerated basis prior to the 30th day if it finds good cause for so doing. After publication, if comment letters on the proposal raise significant issues, the Commission must consider all such comments and will generally ask the SRO to address the material comments. In approving a proposed rule change, the Commission must make findings that the proposal is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to the SRO. The Commission's ability to make such findings is dependent upon the completeness of the SRO's proposal that details its proposed rule change, as well as the SRO's response to comments. Further, certain types of proposed rule changes may become effective immediately upon filing with the Commission. The most common types of immediately effective filings are "non-controversial" proposals and changes to an exchange's fee schedule. Approximately half of the proposed rule changes submitted by SROs in 2005 and 2006 were designated for immediate effectiveness.

As you reference, the Commission and its staff have been working closely with the NYSE on a wide range of matters, including changes to NYSE's trading system to comply with Regulation NMS. Over the past three years, the NYSE has been implementing its "Hybrid Market" trading system, which combines aspects of the exchange's floor-based auction market with electronic trading. During this time, the Commission and its staff have worked to ensure that Hybrid system takes into account the needs of various market participants, including specialists, while satisfying the requirements of the Exchange Act, and its rules and regulations thereunder.

In approving the Hybrid system, the Commission worked with the NYSE to fashion a system that balanced the advantages specialists have by virtue of their unique position against the responsibilities specialists are accorded, including their affirmative obligation to assist in the maintenance of fair and orderly markets and the requirement that a specialist's dealings be restricted, so far as practicable, to those reasonably necessary to permit the specialist to maintain a fair and orderly market. Since Hybrid's initial approval, the NYSE has worked on its proposals to adjust the system. Last year, the Commission approved a pilot program to revise the specialist's stabilization obligations with respect to active stocks and has been in constant dialogue with the exchange regarding further adjustments to the Hybrid system as the NYSE gains experience with its new trading platform and as the securities markets continue to evolve.

With respect to the SRO rule filing process in general, the Commission recognizes that Section 19(b) of Exchange Act affects the timing of exchange rule changes, and the Commission has periodically revised the rule filing requirements to meet the changing needs of the exchanges in a competitive financial marketplace, while at the same time maintaining required oversight of the SRO rule-making process. For example, in 1994, the Commission adopted amendments to Rule 19b-4 to allow certain non-controversial

filings and minor systems changes to become immediately effective.[4] In 1998, the Commission again amended Rule 19b-4, to allow for the listing and trading of certain derivative securities products without first having to submit a proposed rule change under Section 19(b), which helped speed the introduction of new derivative securities products and enable exchanges to remain competitive with foreign and OTC derivatives markets.[5] In 2004, the Commission established an electronic filing system for proposed rule changes to improve the rule filing process by eliminating paper submissions.

Further, the Commission is sensitive to the possibility that SROs may, in certain situations, feel subject to an unlevel regulatory playing field with respect to their non-SRO competitors that trade the same or similar products, including futures exchanges, ECNs, and foreign markets that are able to implement changes to their trading systems without the delay attendant to submitting regulatory filings with the Commission. Exchanges have responded to these competitive pressures as well as recent Commission rulemaking by incorporating new technology and adopting new automated trading systems, as well as changing their business model by restructuring from mutually-owned institutions into publicly-traded for-profit entities. In particular, the Commission recently approved several new SRO electronic trading systems for both stock and options, many of which involved far-reaching market structure changes. Accordingly, subsequent non-controversial changes to these trading systems that do not significantly alter an exchange's market structure or introduce anti-competitive or unfairly discriminatory aspects to its operation may be eligible for designation as immediately effective proposals. In particular, immediate effectiveness of these types of modifications to SRO trading systems allows SROs to more quickly respond to competitive pressures from non-SRO competitors.

In addition, the SROs themselves play a crucial role in the ability of the Commission to expeditiously process rule proposals. Particularly with respect to those proposals that must be acted upon by the Commission, the Commission's ability to make the findings required to approve a proposal as consistent with the Exchange Act and all applicable rules and regulations is dependent upon the completeness of the SRO's proposal that details its proposed rule change. Therefore, SROs can help expedite the process by ensuring that their proposed rule changes are thoroughly described, adequately analyzed, and clearly presented.

Overall, the Commission continues to believe that investors are best served by the current SRO rule filing process specified in the Exchange Act, as it provides a regulatory structure that facilitates competition among market participants while promoting the protection of investors and the public interest. Nevertheless, we will continue to evaluate and adjust the SRO rule filing process, in a manner consistent with the framework established by the Exchange Act, in response to changes in the financial marketplace,

---

4 Securities Exchange Act Release No. 35123 (December 20, 1994), 59 FR 66692 (December 28, 1994).

5 Securities Exchange Act Release No. 40761 (December 8, 1998), 63 FR 70952 (December 22, 1998).

including recent changes to SRO market structure and trading system technology, to ensure that rule proposals are processed efficiently and expeditiously in a manner that facilitates the Commission's oversight of the SRO rule-making process.

Market Data

Broker-dealers argue they will be compelled to purchase the market data products for which approval is pending at the SEC in order to comply with the SEC's "best execution" rules. If that is the case, the New York Stock Exchange and NASDAQ—which control the raw data from which market data products are constructed—arguably could enjoy the equivalent of a government-sanctioned monopoly. Please clarify what the broker-dealer requirements are under the SEC's best execution rules. Would the best execution rules require the purchase of the market data products proposed to be offered by the New York Stock Exchange and NASDAQ? When will the Commission issue guidance on these issues?

ANSWER:

A broker-dealer has a legal duty to seek to obtain best execution of its customer orders. The duty derives from common law agency principles and is incorporated in SRO rules and, through judicial and Commission decisions, the antifraud provisions of the federal securities laws. In general, the duty of best execution requires broker-dealers to seek to execute customer orders at the most favorable terms reasonably available consistent with the circumstances.

The first step in assessing the best execution requirements of broker-dealers with respect to market data is to recognize the important distinction between "core" data and "non-core" data. Core data is the best-priced quotes and all trades of exchanges and NASD members. It is required to be disseminated on a consolidated basis by central processors pursuant to joint-SRO plans. Rule 603(c) of Regulation NMS (known as the "Vendor Display Rule") generally requires data vendors and broker-dealers that provide individual market data to their customers, to provide comprehensive core data to their customers in trading and order-routing contexts. Non-core data, in contrast, is distributed by individual exchanges and broker-dealers and encompasses all data other than the consolidated core data feeds. The most significant type of non-core data is depth-of-book order data – the quotes of an individual market outside its best-priced quotes available through the core data feeds.

When it adopted Regulation NMS in 2005, the Commission streamlined the Vendor Display Rule to expand the extent to which competitive forces, rather than regulatory requirements, determine what, if any, additional quotes outside the national best bid and offer ("NBBO") are displayed to investors.[6] It emphasized that investors who need more comprehensive depth-of-book order information would be able to obtain such data from markets or third party vendors.

---

[6] Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496, 37567 (June 29, 2005) ("Regulation NMS Release").

Whether broker-dealers must purchase the depth-of-book order data of any particular exchange to meet their best execution obligations is an issue presented for Commission consideration in the NetCoalition matter.[7] The Commission intends to issue an order resolving the NetCoalition matter within the next few months.

Merging of Broker and Adviser Roles

> Question: The delivery of investment advice to individuals has attracted considerable attention in the wake of the ruling by the D.C. Circuit (FPA v. SEC). Additionally, as the SEC has previously noted, the differences between broker-dealers and investment advisers "have begun to blur, raising difficult questions regarding the application of statutory provisions written by Congress more than half a century ago." In response to this recent court ruling, the SEC has expedited the study by the RAND Corporation of these matters, in addition to taking other actions.
>
> The Commission sought a 120-day stay of the effectiveness of the decision to allow the markets and accounts to adjust. What position does the Commission intend to take with respect to fee-based brokerage accounts for the interim period after the stay terminates but before receipt of the RAND study and further regulatory action?

ANSWER:

We are currently determining how to deal with any issues affecting fee-based brokerage accounts for the three month period after the stay terminates but before receipt of the RAND study. In doing so, we are guided by the court's decision. In the future, advice provided by broker-dealers to customers in fee-based accounts will be subject to the fiduciary duty already imposed on investment advisers. We will not determine what long-term regulatory action is needed until we have received and evaluated the RAND study and the implications of its findings.

> Question: What is the current time frame for receiving this report and making it public? Does the SEC anticipate that this report will make legislative recommendations about the need to update the investor-protection framework established in the wake of the Great Depression to reflect the increasingly integrated delivery of diverse financial services and investor expectations in today's marketplace?

ANSWER:

---

[7] In the Matter of NetCoalition, Securities Exchange Act Release No. 55011 (December 27, 2006) (order granting petition for review and scheduling filing of statements).

Chairman Cox approved additional emergency funding to accelerate the completion of the RAND study, which will be delivered to the Commission by the end of December 2007. The RAND study is an empirical study of collected data; it will not make policy recommendations. The Commission intends to use the study's findings as factual background for evaluating the current legal and regulatory environment for the provision of financial products, accounts, programs and services to individual investors by broker-dealers and investment advisers. The Commission will also use the findings to determine, consistent with the Commission's legislative mandate, the most effective legal and regulatory approach to regulating investment professionals in today's marketplace. Until the study is complete and we better understand the nature and extent of the problem, however, it would be premature to speculate regarding the most appropriate long-term solutions to these issues.

> Question: Some participants in the securities industry have already suggested that the application of a fiduciary duty, as opposed to a suitability standard, on every professional who offers advice to investors. Please review the implications of applying a fiduciary standard to all securities professionals offering investment advice.

ANSWER:

Investment advisers are fiduciaries by virtue of the nature of the position of trust and confidence they assume with their clients. They owe their clients "an affirmative duty of 'utmost good faith, and full and fair' disclosure of all material facts."[8] Broker-dealers have been held to similar standards where, for example, they assume positions of trust and confidence with their customers. In addition, all broker-dealers, like all investment advisers, must only make suitable recommendations to their customers. For investment advisers, this obligation is one of their fiduciary obligations. For broker-dealers, it stems from SRO rules, and the shingle theory, which requires broker-dealers to deal fairly with their customers and in accordance with industry standards.

> Question: Additionally, broker-dealers presently operate under a mandatory arbitration standard, while individuals may take their investment advisers to court. Please detail how these different dispute resolution mechanisms might produce a different application of a fiduciary standard for customers of securities professionals with different types of designations.

ANSWER:

The rules of self-regulatory organizations ("SROs") require their members to arbitrate any eligible dispute submitted by a customer. Customers are not, however, required by SRO rules to arbitrate these disputes. Rather, customers generally agree to arbitrate these disputes in the contracts they sign when they open brokerage accounts. The Federal

---

[8] *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963).

Arbitration Act established a federal policy favoring arbitration, requiring that the courts rigorously enforce arbitration agreements. This reflects Congress's view that arbitration is a reasonable alternative to litigation. Whether a customer dispute is settled by an arbitrator sitting in equity or by a court, we would not expect applicable standards to vary.

Options Penny Trading

The options markets are in the midst of a pilot program on penny quoting and trading for 13 classes of options. Early assessments of this pilot have found increases in quote traffic and decreases in spreads. What other conclusions has the SEC reached about this pilot?

Additionally, this pilot program is currently scheduled to end in late July. What steps does the SEC plan to take at the end of this pilot period?

ANSWER:

Data contained in recent reports from the six options exchanges, as well as analysis by the Commission's Office of Economic Analysis, show that the Pilot has been successful in narrowing average quoted spreads and has contributed to a manageable increase in quotation message traffic. In addition to these findings, the Commission has observed that there has been an expected reduction in the displayed size available at the best bid or offer in the Pilot classes. Based on conversations with the options exchanges and other industry participants, the staff believes that sufficient size remains to satisfy retail orders. Nonetheless, the Commission is mindful that concerns have been raised about decreased liquidity and that any decreased liquidity for institutional orders may affect retail investors. The Commission will carefully consider the effects of decreased liquidity before expanding the Pilot.

Based on the Pilot results, the exchanges filed immediately effective proposed rule changes to extend the current pilot. With respect to expansion of the Pilot, Commission staff is discussing with the exchanges which additional options it would be most beneficial to investors to trade in smaller increments. Staff has not concluded that penny quoting in all options is appropriate. Before acting on any exchange proposals to expand the Pilot, the Commission will carefully consider the expected impact on market quality and quotation traffic.

Fair Funds

The Fair Funds provision of the Sarbanes-Oxley Act allowed the SEC to return the disgorgements that it collects to defrauded investors. In the testimony submitted for the hearing, the Commission also noted that it had "returned over $1 billion to injured investors" since 2005. The agency, however, did not provide a figure concerning the amount remaining for distribution. Please provide information related to the aggregate amount collected for Fair Funds by the SEC since inception, the aggregate amount

ordered (but not necessarily collected), the aggregate amount distributed, and the aggregate amount to be distributed. Please also provide information on how the amounts ordered to be obtained through SEC enforcement actions compare to amounts awarded in private suits in the same or similar cases?

In a letter sent to Congressman Kanjorski on June 26, 2006, Chairman Cox indicated that the SEC had returned approximately $700 million to harmed investors at that time and that the SEC held about $3.3 billion for distribution at that time. The letter also stated that "[w]e expect a substantial portion of the remaining Fair Funds to be distributed this year." Why did the SEC fall short of meeting this self-imposed expectation?

Finally, the SEC has now created a new office to coordinate and oversee the administration of the Fair Funds and is implementing a number of reforms to track, collect, and distribute these monies. Describe how this new office and reforms will help to distribute restitution to defrauded investors. What more can be done to improve the implementation of this law?

ANSWER:

Fair Fund Amounts
The Division of Enforcement's provisional internal management system indicates that the Commission has collected approximately $8.6 billion for distribution to injured investors. The amount ordered for distribution (but not necessarily collected) is approximately $8.9 billion. The Commission has distributed approximately $2.18 billion and approximately $6.2 billion remains to be distributed. The Commission is currently in the process of enhancing its management information systems. We anticipate we will have better systems to more precisely record and track data regarding Fair Funds when this effort is complete.

Private Lawsuits
The Commission is not able to provide a comparison of the amounts awarded in private securities suits to the amounts ordered in SEC enforcement actions because the Commission does not collect data on private actions. Moreover, any comparisons between amounts collected in SEC actions and private actions would need to take note of the fact that amounts awarded as disgorgement and civil penalties in SEC actions may be quite different from amounts obtainable as damages or restitution in private suits involving the same or similar conduct.

Distribution Challenges
As noted above, the Commission has distributed approximately $2.18 billion to harmed investors. We are pleased that we have now distributed roughly three times the amount we had distributed at the time of Chairman Cox's June 26, 2006 letter to you. We recognize that a substantial amount remains to be distributed and we are committed to doing our utmost to ensure that these funds are distributed fairly and expeditiously.

The Commission is proceeding in a deliberate and precise manner to ensure that it meets its responsibilities to investors. Developing and administering a distribution plan is a complex task that includes culling fraudulent or mistaken claims; determining what classes of investors, during what time period, were harmed; fixing the relative harm to each particular class of investor; and assessing what constitutes an equitable allocation, as well as resolving the myriad practical questions involved in transferring funds to what can be millions of individual claimants.

Fair Funds arising from cases involving mutual fund market timing abuse, which account for a substantial portion of the amounts ordered for distribution, have posed the greatest challenges. The distributions in these mutual fund matters differ from the Commission's past distributions in a number of ways. Due to the nature of the mutual fund scandal, these matters involve small injuries to huge numbers of individual investors, which makes the distribution process difficult. Sophisticated analyses are required to first identify the fraudulent trades and then to calculate the harm to investors. These losses are not readily apparent to the investor. As a result, these distributions do not involve a process by which notice is sent out to investors, and claims are made. Instead, the fund administrators are faced with the more time-consuming task of identifying the harmed individuals and estimating their losses using factual data from the respondents and third parties.

In addition, our staff overcame significant challenges to the distribution process in connection with distributions made by Fair Funds to retirement plans and certain tax obligations of the Fair Fund. The staff worked closely with representatives of the IRS and the Department of Labor to clarify the law in these areas. Although the guidance received from the IRS and DOL delayed distributions for many months, the decisions ultimately rendered have created precedents that will ensure that future Fair Funds can distribute funds more quickly.

The Commission continues to evaluate its processes to streamline procedures so that monies are returned to investors efficiently, effectively, and in a timely manner.

New Office to Oversee Fair Funds

The Commission is establishing a new office to improve the management of the Fair Fund Program. This new office will be within the Division of Enforcement and be called the Office of Distributions, Collections, and Financial Management. It will be led by a Senior Officer (SO) and two Assistant Directors (SK-17s). The new office will be divided into two groups, each of which will be headed by one of the Assistant Directors – 1) the Fair Fund Distributions and Collections Unit and 2) the Financial Information Management Unit. We are in the process of more fully developing the specific responsibilities of this office and adding new staff to assure the improved distribution of funds to investors.

Fair Fund Improvements

As enacted, the Fair Fund provision only permits the Commission to add penalty amounts to disgorgement funds when a penalty is collected from the *same defendant* that has been

ordered to pay disgorgement. There are cases, however, where some defendants may *not* be ordered to pay disgorgement and it would be beneficial if the Commission could distribute penalties collected from these defendants (as well as from defendants who *are* paying disgorgement) to harmed investors in that case. Indeed, in some cases, the Commission may not obtain disgorgement from *any* defendant, but may obtain civil money penalties. In such cases, it might nevertheless be feasible to create a distribution fund for the benefit of victims in that case. The Commission has proposed an amendment to the Fair Fund statute that would allow the Commission to add civil penalties to a fund for distribution to the victims of a securities law violation regardless of whether the Commission also obtains disgorgement against the violator.

The Fair Funds provision could also be improved if distribution funds established in SEC actions were made exempt from federal taxation under current IRS regulations on qualified settlement funds. Considerable time, effort, and expense are incurred by the Commission and the Funds in meeting quarterly and annual tax reporting requirements.

Questions Submitted by Mr. Green:

Enforcement Policy

Under the new policy governing monetary penalties in enforcement actions against public companies, the SEC staff would be required to obtain Commission approval before engaging in negotiations for settlements.

- Can each Commissioner tell me whether you think that replacing the independent judgment of professional SEC staff with a decision influenced by political appointees will result in politicization of the enforcement process?
- Chairman Cox has stated that the new policy would give staff more "negotiating leverage." Can each Commissioner tell me whether you believe that this increased "negotiating leverage" will result in increased investor protection or will it result in lower monetary penalties on public companies?
- Chairman Cox, you have said that you consider this plan "totally as an experimental pilot" that will be abandoned "if it does not work well." Can you define what "not work well" means to you? How will you define whether this pilot program is a success or failure? Will the size of the monetary penalties be a factor in determining the success or failure of the policy? How will you determine whether investors are better protected under the new policy?

One reason given for this new SEC policy is that it will result in "more productive and fast-tracked negotiations." Under the new policy, supporters argue, the Commissioners will be on the same page with the SEC staff prior to a settlement being negotiated.

- Can the Commissioners tell me what the problems were, and the extent to which those problems existed, with the previous policy such that this change in policy was necessary? Were there complaints of inadequate investor protection? Do you think the benefits of streamlining the process and having more speedy outcomes is worth the risks that may result from changing the current system?
- Can you tell me how often the Commission sent the enforcement unit back to the drawing board to renegotiate a settlement under the current policy?
- Is there something inherently wrong or harmful with having the process as it existed before, where the Commissioners served as an "appeals court" rather than a trier of fact? Isn't this a more effective way for the Commission to communicate its policy views to the staff, rather than on a case-by-case basis?

One of my concerns regarding this new policy is that the Commissioners will be making or helping make recommendations without having the case fully-developed. Under the current process, SEC staff typically will bring enforcement recommendations to the Commission based on 2 scenarios. In the first scenario, the staff brings the proposed settlement (to which the defendant has already agreed) supported by a lengthy staff memorandum describing the evidence and legal issues in the case and recommending that the Commission authorize the settlement. In the second scenario, the SEC staff will bring a recommendation that a "non-settled" enforcement action be authorized (*i.e.* the defendant has not agreed on the enforcement action) supported by a staff memorandum

and accompanied by a "Wells" submission from the defendant setting forth the reasons why the staff's recommendation should be rejected or narrowed.

- In both scenarios, enforcement recommendations have reached the Commission in a fully-developed state. Under the new policy, the Commission will be recommending decisions without the benefit of the give-and-take of settlement negotiations or without the defendant having the opportunity to be heard via a Wells submission. This is similar to having a judge render a verdict without the benefit of hearing both the plaintiff and defendant argue their sides of the case. Can the Commissioners tell me whether they believe that this new policy will adversely affect the quality of the Commission decisions?
- Who is in a better position to determine a proper outcome in these cases, a Commissioner who reviews a case after a negotiated settlement has been reached (or in the alternative, after reading the SEC staff's recommendation and the defendant's "Wells" submission) or a Commissioner who does not have the benefit of this intelligence?
- Under the new policy, is it possible to develop a mechanism by which the Commissioners could hear the arguments of both the SEC staff and the defendant? One approach that has been suggested is for the SEC staff to inform defense counsel that the staff is going to the Commissioners and to allow for staff-defense counsel meetings and memoranda similar to a "Wells" submission. Couldn't this process result in unnecessary expense for corporations that they would have to incur before they even enter into settlement negotiations? In other words, under the current policy, only corporations that did not reach settlement would have to pay that expense, while under this proposed solution to the new policy, all corporations would have to pay that expense, even those that would eventually choose to reach settlement.

ANSWER:

We are pleased to address at greater length the Enforcement Division's pilot program for seeking Commission settlement authorization prior to beginning settlement discussions in cases involving possible corporate monetary penalties. The following answer provides a short description of the new approach and attempts to answer the various questions concerning it. Except as otherwise noted in the supplementary answers at the end of this document, this answer is on behalf of all the Commissioners.

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

Against the backdrop of the Commission's over 70-year history, the current process for consideration of enforcement matters at closed meetings allows for more staff discretion and for less Commission oversight than has been the traditional norm. As recently as the 1970s, all cases of all kinds were submitted for Commission consideration prior to the initiation of settlement discussions. The recently initiated pilot procedure, in

contrast, applies only to the very small number of corporate penalty cases each year, in which early implementation of the Commission's recent and unanimous penalty guidelines is of exceptional precedential importance. Moreover, the procedure maintains the collaborative process between the Commissioners and the staff – with the staff providing invaluable advice to the Commission, and the Commissioners supplying their views and general settlement guidance to the staff. The procedure does not replace the independent judgment of the SEC staff. Rather, it provides a means for the staff to discuss cases and possible resolutions at a more meaningful point, before the negotiation of the settlement and its terms is concluded.

The pilot program[9] has the following objectives:

- *Provide clarity, consistency, and predictability in the imposition of monetary penalties.* In January 2006, the Commission unanimously agreed on a statement concerning financial penalties against corporations. With SEC offices across the country handling cases of this type the Commission must work diligently to ensure that these Commission-enforcement principles are applied consistently. Providing horizontal equity in a nationwide program sends a clear message to the markets about the costs of engaging in illegitimate behavior, and the importance of compliance with legal norms.

- *Strengthen the Commission's enforcement program.* By providing the views and recommendations of the staff to the Commission at a time that settlement negotiations are to begin, the procedure will allow the staff to enter upon those negotiations with the full support of the Commission. When enforcement lawyers in settlement discussions sit across the table from outside counsel, we want them to know they will not be second-guessed by the Commission at a later stage.

- *Streamline the settlement process.* By shortening final Commission review and approval if the staff reaches a settlement within the guidelines set with the Commissioners, the procedure is intended to make the entire enforcement process speedy and more efficient.

- *Maintain fairness to potential defendants and respondents.* By providing an opportunity to provide written submissions on potential enforcement actions prior to Commission consideration, the procedure guarantees due process to those who are subject to Commission enforcement action.

Because the pilot procedure takes effect at the end of the normal investigation process, the entirety of the process continues unchanged. The procedure provides the Commission with the benefit of a staff recommendation, and a submission by the subject of an investigation, after a case has been fully developed. If the staff believes it is likely

---

[9] At present, the procedure does not apply in all cases and does not apply to a potential settlement with a corporation when a penalty is considered for conduct related to a line of business regulated by the Commission, such as conduct as a broker-dealer or investment adviser.

to recommend an enforcement remedy that includes a corporate monetary penalty, the staff first informs the company of a possible proceeding, and provides it with an opportunity to make a written submission about the case and the possibility of monetary penalties (in accordance with section 202.5(c) of Commission rules). The company, as in other cases, is free to choose whether to make a submission. The staff then prepares an enforcement recommendation for the Commission to consider, which will include possible charges, sanctions, and monetary penalties.

The Commissioners then have the opportunity to discuss the case with the Enforcement staff, and to learn their views about ranges of outcomes that should be acceptable if the company decides to settle. If the Commissioners agree that an enforcement proceeding seeking a corporate monetary penalty is warranted, the Commission will authorize a proceeding and settlement discussions to reach a settlement consistent with the Commission's theory of the case, within the range of settlement guidelines the Commissioners have identified. If the staff reaches such a settlement, final Commission approval of it will occur on an expedited basis without the need for a further closed meeting. The staff may always return to the Commission to recommend a higher or lower penalty range, or lesser or greater charges or non-monetary sanctions, if their recommendation changes based on new information or a development that occurs during the settlement negotiations.

There are several benefits to this procedure. When the staff presents fully negotiated settlement terms to the Commission for approval, without prior consultation, the Commissioners' exercise of judgment and discretion in determining the appropriate outcome for a case can be limited. Modifying the terms of a fully negotiated settlement can often be challenging. Moreover, when the Commission votes to upset a settlement reached independently by the staff, this could undercut the bargaining power of the staff in the agency's nationwide program in future negotiations. A further disadvantage to reopening completed settlements is that the enforcement process is prolonged and delayed. In these circumstances, potential defendants and their shareholders face new uncertainty, and limited government resources are used inefficiently.[10]

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

[10] You inquired about how frequently the Commission votes to reopen settlements in corporate penalty cases that have been agreed to between staff and the subject of a proposed or pending enforcement action. In the five-year period from 2002-2006, the Commission brought an average of approximately 6 corporate penalty cases per year. Within this relatively small universe of cases (by way of providing context, the Commission brought 574 enforcement actions overall in 2006 alone), only a small number are reopened – in part because of the Commission's reluctance to do so for the programmatic reasons stated in the body of this response.

investor protection by strengthening the position of the staff to obtain results that the Commission believes are appropriate and by bringing clarity and consistency to the imposition of monetary penalties.

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

Broker Voting

To eliminate the possible distortions of broker votes, the NYSE has proposed to eliminate broker voting in all director elections via changes to NYSE Rule 452. The SEC has not taken any action on this proposed rule.

QUESTION:

- Can you explain why the SEC has not taken action on the NYSE proposal?

ANSWER:

The NYSE recently amended its proposal to address concerns raised by the Investment Company Institute. The Commission staff is carefully reviewing the proposal, as amended. In addition, the Commission is considering broker voting in connection with the entire proxy voting process and expects to formulate its views on broker discretionary voting, along with the broader issues surrounding shareholder voting and communications. The Commission recently hosted a series of roundtable discussions concerning the entire proxy voting process including a roundtable to discuss broker discretionary voting issues. During the roundtable a variety of alternatives were discussed.

QUESTION:

- Some business groups have warned that eliminating broker votes might raise election costs for companies because of the extra effort they must expend to get shareholders to vote. Is there a way to help firms lower the cost of this communication with shareholders?

ANSWER:

The NYSE Proxy Working Group recognized that, if a company fails to achieve a quorum for a shareholder meeting, the company may have to adjourn its meeting to solicit additional votes and that this is likely to be a time consuming and expensive

process. The Working Group did not want to create a situation where issuers are unable to achieve a quorum or conduct such fundamental business as electing directors. It therefore recommended retention of the broker vote for routine matters other than the uncontested election of directors. Under Delaware law and many other state laws, the broker vote will count for quorum purposes as long as one matter that is considered routine under NYSE Rule 452 appears on the ballot, such as ratification of the auditor. The Working Group concluded that, based on its analysis of empirical data for NYSE listed companies, eliminating the broker vote would likely have only a relatively minor impact on the outcome of the election of directors. Because investment companies often do not have another routine matter on their ballot, NYSE has amended its proposal to exclude investment companies from its proposal.

To mitigate any potential impact that eliminating broker voting of uninstructed shares in director elections could have on companies, the Working Group separately recommended that the NYSE support efforts to improve the ability of issuers to communicate with their beneficial owners. It found that many investors did not understand the voting process and the distinction between objecting beneficial owners (OBOs) and non-objecting beneficial owners (NOBOs) and believes that with more education more investors would opt to be NOBOs, which could help address the access issue and costs associated with soliciting proxies. Accordingly, the Proxy Working Group has established an Education Sub-Committee to determine how best to educate investors to achieve greater shareholder participation in the proxy voting process, including providing shareholders with a better understanding on the OBO/NOBO status.

QUESTION:

- Brokers generally vote for management partly, they say, because if clients wanted them to oppose management, they would let then know. Do you think this assumption is valid? Shouldn't we assume that the shareholders who don't vote have the same state of mind as those who do vote? If so, why not have "proportional" voting and require that brokers vote uninstructed shares in proportion to those cast by other retail investors? Wouldn't this option avoid some of the problems associated with NYSE proposed rule?

ANSWER:

Proportional voting is a possible alternative to the NYSE rule proposal and was discussed at the Commission's roundtable on broker discretionary voting. Proportional voting could be desirable for issuers since brokers could vote uninstructed shares and these shares would be counted to meet quorum requirements. The Securities Industry and Financial Markets Association recently encouraged its members to consider voting uninstructed retail shares in proportion to the voting instructions each broker receives from its retail clients. Several large broker-dealers have agreed to do this during the 2007 proxy season. In proportional voting, there are several interpretive issues that would need to be addressed for calculating the proportion of the vote to be mirrored such as

whether only the retail vote should be counted and whether it should be counted broker by broker or in proportion to all votes cast by all brokers. Some issues of concern that have been raised by market participants with proportional voting is that it would continue to assign votes to uninstructed shares and that proportional voting would afford more weight to the shareholders that actually vote.

QUESTION:

- As another option, why couldn't we move to "client-directed" voting? In other words, why couldn't we have the retail investor give general voting instructions to his or her broker when signing the brokerage account agreement? That way you could count "pro-management" broker votes as long as the brokerage agreement explicitly authorized the broker to vote in favor of management.

ANSWER:

Client-directed voting is another alternative that was discussed at the Commission's roundtable on broker discretionary voting. Under this alternative, brokerage firm clients would make their default voting preferences known at the signing of the brokerage agreement, and the broker would vote that client's shares consistent with those instructions in the event the client otherwise fails to provide voting instructions. Since uninstructed votes could still be voted by the broker, this alternative could address some issuer concerns. Client-directed voting, however, may raise concerns because the client (beneficial owner) is being asked to make a voting decision prior to receiving any proxy materials.

QUESTION:

- As a final option, why couldn't we extend the 10 day period after which the broker votes for the retail investor to give the broker time to proactively contact the retail investor and tell him or her how he will be voting?

ANSWER:

Brokers currently send shareholders a letter that indicates which items will be voted by the broker if the instructions are not returned by the shareholder within the set time period. There may be issues with the timing of the proxy process for issuers if the time period were extended. The NYSE Proxy Working Group's Education Sub-Committee is focusing on how to best educate the retail investor on the proxy voting process.

Question submitted to Chairman Cox by Ranking Member Spencer Bachus

Customers of a broker-dealer receive the full regime of prospective, self-regulatory protections coupled with SEC oversight. These protections help to promote vigorous compliance programs and bolster the Commission's supervisory efforts. As a result of the decision by the United States Court of Appeals for the District of Columbia Circuit in *Financial Planning Association v. SEC*, many investor accounts will be subject to a new regulatory regime that governs investment advisers, which is very different from the broker-dealer regulatory oversight system that has been in place for nearly 70 years. What assurances can the Commission provide that the differing regulatory regimes will continue to protect investors and promote stability and confidence in our capital markets?

ANSWER:

We are devoting substantial attention to the difficult issues that have arisen as a result of the Court's decision in *Financial Planning Association v. SEC*. As you are aware, we requested a 120-day stay of the ruling, which the Court approved, to work with the firms on transition issues and to consider further action by the Commission with respect to the application of the Investment Advisers Act to the affected accounts. I met recently with representatives of the brokerage industry and other members of the Commission's senior staff have had multiple meetings with representatives of all groups affected by the Court decision. We are working hard to arrive at an approach with respect to these accounts for the period following expiration of the stay and until a permanent solution can be devised in light of the findings of the RAND study on industry conditions that will protect investors, facilitate investor choice, and be possible under our current statutory authority.

I also approved additional emergency funding to accelerate an on-going outside study of the marketing, sale, and delivery of financial products and services to investors by investment advisers and broker-dealers. The study by the RAND Corporation will be delivered to the Commission no later than the end of December 2007, several months ahead of schedule. The results of the study are expected to provide an important empirical foundation for considering improvements in regulatory and legislative provisions that, as you note in your question, date back to the 1930s.

Rep. Ed Royce (CA-40)
Question for the Record

Question to the Commission:

There has been much focus in recent years on the credit rating agencies and their role in the capital markets. However, it seems as though there may still be some confusion about what the credit ratings can and cannot do. As I understand it, the credit rating industry provides opinions on the relative credit risk of a debt instrument or issuer.

Last year, the Financial Services Committee helped pass legislation to improve ratings quality in the credit rating agency industry. Last month, the Commission published final rules to that end. I would like to commend you and your staff for your efforts and results in this regard.

Mr. Chairman, it is my hope that the Commission's new Nationally Recognized Statistical Rating Organizations (NRSRO) registration and oversight system will help to further clarify the role of credit rating agencies, which is to provide credit opinions to the market. I would appreciate the Commission's comments regarding the industry's role in our credit markets.

ANSWER:

Credit rating agencies provide opinions on the creditworthiness of issuers of securities and their financial obligations. The importance of these opinions to investors and other market participants, and the influence of these opinions on the securities markets, has increased significantly, due, in part, to the increase in the number of issuers and the advent of new and complex financial products, such as asset-backed securities and credit derivatives. Today, credit ratings affect securities markets in many ways, including an issuer's access to capital, the structure of transactions, and the ability of fiduciaries and others to make particular investments.

Investors use credit ratings to make investment decisions. Large public institutions, such as pension funds, use credit ratings to prescribe the types of securities the institution is permitted to hold. Creditors, such as commercial and investment banks, also use credit ratings to manage credit risk and govern transactional agreements. In addition, while the Commission originated the use of the term "nationally recognized statistical rating organization" or "NRSRO," in its broker-dealer net capital rule, other regulatory bodies have come to rely on NRSRO ratings. Today, NRSRO ratings are widely used for distinguishing among grades of creditworthiness in federal and state legislation, rules issued by financial and other regulators, and even in some foreign regulations.

As you know, on May 23, 2007, the Commission voted to adopt final rules to implement certain provisions of the Credit Rating Agency Reform Act of 2006 ("Rating Agency Act"). The Senate Report on the Rating Agency Act stated the purpose of that Act is to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry. The Commission rules implementing the Rating Agency Act are consistent with these goals.

Under Commission rules, a credit rating agency seeking to be treated as an NRSRO must apply for registration with the Commission and make public certain information to help users of credit ratings assess an NRSRO's credibility and compare the NRSRO with other NRSROs. This required disclosure includes information about its credit ratings performance statistics (in terms of credit defaults); its methods for determining credit ratings; its organizational structure; its procedures to prevent the misuse of material nonpublic information; the conflicts of interest that arise from its business activities; its code of ethics; a description of the minimum qualifications of its credit analysts and credit analyst supervisors; and information regarding its designated compliance officer. The rules also require an NRSRO to make and retain certain records; to furnish the Commission with annual audited financial statements and certain other unaudited financial reports; and to implement policies and procedures addressing the handling of material nonpublic information and conflicts of interest. Finally, the rules prohibit certain unfair, coercive or abusive practices.

The Commission notes that each of the seven credit rating agencies previously identified as a NRSRO under a staff no-action letter has applied to be registered with the Commission as a NRSRO (two were just recently granted Commission no-action letters for the first time). The Commission believes that this new registration, disclosure, and oversight system will allow users of credit ratings to better compare the credit ratings quality and integrity of different NRSROs. The Commission rules implementing the Rating Agency Act are designed to increase the transparency of their operations and encourage competition in the credit rating industry.

Question submitted to Chairman Cox by Mr. Jones of North Carolina

Soft Dollars

Chairman Cox, I understand that you recently wrote to this committee urging that Congress repeal or substantially revise current securities law permitting the use of "soft dollars" to pay for research. However, I understand that it was just one year ago that the Commission put out a guidance document on this subject which did a great deal to provide transparency about these soft dollar arrangements and clarify what exactly they could pay for. I'm concerned that one year later, if we follow your letter suggesting that we eliminate soft dollars, it could have the perverse impact of hurting smaller investors, as research from smaller independent broker-dealers and research providers disappears. Do you really want such a result?

ANSWER:

The guidance the Commission issued last year regarding "soft dollar arrangements" reflects the Commission's continuing effort to administer the law as Congress wrote it in 1975. My letter recommending repeal or substantial revisions of current law that protects these arrangements raised larger questions of public policy. The letter expressed my concern that this provision of the law may hurt investors and U.S. capital markets by protecting arrangements that involve substantial conflicts of interest, contributing to higher brokerage costs, and operating to impede the further development of efficient markets for brokerage as well as advisory services.

My letter also discussed the difficulty of administering a law that requires the constant involvement of lawyers in business decisions that should be made based solely on the best interest of clients. Last year's guidance document you refer to was the SEC's third comprehensive interpretation of the safe harbor, and it required the parsing of terms and legislative history written over thirty years ago. Yet since that guidance document was issued, our staff has continued to field many inquiries regarding the availability of arrangements that Congress could not have envisioned when it enacted the soft dollars safe harbor. The securities industry is accustomed to the rigors of competitive commissions and rapid innovation in financial research and products. I am confident that this industry, including its smaller members, would be able to adjust to a more transparent market for brokerage and research services.

Market Data Fees

Chairman Cox, I understand that earlier this year, the Commission took the unusual step of granting the petition of the NetCoalition to review a market data fee increase proposed by the New York Stock Exchange. Now that the SEC has taken that action, it seems to me that it, rather than approving further fees on a case-by-case basis without a clear sense of what fees are "fair and reasonable" it would be most appropriate for the Commission first to conduct a broad review of market data fees generally and the issues raised by the NYSE fee proposal, to establish a clear framework and guidelines for how other fee

increases are to be handled in the future. Can you advise me as to the SEC's plan in that regard?

ANSWER:

The Commission currently is reviewing a broad range of market data issues raised by the filings pending with the Commission or the Commission's staff. In November 2006, the NetCoalition, a public policy voice for certain Internet companies, petitioned the Commission to review an order, issued by the Commission pursuant to delegated authority, approving a proposed rule change filed by NYSE Arca, Inc.[11] The proposal sought to establish fees for the receipt and use of certain market data that consists primarily of a compilation of all orders resident in the NYSE Arca limit order book. This type of information is commonly referred to as "depth-of-book" order data. In December 2006, the Commission issued an order granting NetCoalition's petition and allowing any party or other person to file a statement in support of or in opposition to the action made by delegated authority.[12]

Commenters submitted statements sharply disagreeing on whether the specific NYSE Arca proposal should be approved, as well as on a variety of broader market data issues. These issues include, for example: (1) the level of fees for "core" data that is required to be consolidated and distributed by a central processor pursuant to joint-industry plans, as well as the use of those fees in funding the self-regulatory organizations ("SROs"); (2) the quality of the consolidated core data feeds, including their speed and content, when compared with the quality of non-core data feeds distributed by individual exchanges and market participants; (3) the conversion of many exchanges from membership organizations to for-profit public companies and the effects of this change on market data products and fees; (4) whether the increasing importance to data users of non-core, depth-of-book order data requires a change in the regulatory treatment of such data; (5) whether the total of all fees from depth-of-book data products distributed by the various markets has reached, or is likely to reach, an unreasonably high level; and (6) whether the SROs and joint-industry plans should provide greater public disclosure concerning their market data revenues and costs. In addition, a number of proposed rule changes submitted by SROs other than NYSE Arca present the same or analogous market data issues.

Given the importance and complexity of the issues raised in the NetCoalition matter and by other SRO market data proposals, the Commission necessarily has acted deliberately to reach considered decisions supported by substantial facts and analysis. These decisions will need to reflect multiple Exchange Act objectives, including: (1) assuring high quality information for investors that enables them to obtain best execution of their orders and otherwise achieve their trading and investment objectives; and (2) promoting

---

[11] Securities Exchange Act Release No. 54597 (October 12, 2006) 71 FR 62029 (October 20, 2006).

[12] In the Matter of NetCoalition, Securities Exchange Act Release No. 55011 (December 27, 2006) (order granting petition for review and scheduling filing of statements).

fair competition among broker-dealers, exchange markets, and markets other than exchange markets.

I recognize, however, the pressing need for action on all pending SRO market data proposals. The U.S. equity exchanges operate in an intensely competitive environment. They need certainty and finality concerning their rule proposals and applicable regulatory requirements so that they can adjust their business strategies accordingly. The Commissioners and staff have focused intensely on market data issues in recent months. I anticipate that the Commission will consider the NetCoalition matter within the next few months. At that point, the Commission should be in a position to act on the additional SRO market data proposals without significant further delay.

Questions submitted by Representative Scott Garrett

StoneRidge

QUESTION: The general incongruity between certain SEC pro- and anti-competitive policies: The SEC has recently shown appropriate sensitivity to U.S. competitiveness concerns. For example, on June 13th, the SEC held a roundtable discussion on "mutual recognition" of foreign regulatory regimes, which would allow foreign broker-dealers and stock exchanges to provide products and services to US investors (without registering with the SEC). Yet, at the same time, in the *Stoneridge* Supreme Court case, the SEC took a distinctly anti-competitive view to expand the scope of class action lawsuits to include third parties, which would unnecessarily generate additional litigation and cost billions of dollars to US businesses. **Moreover, the SEC's position would potentially expose to third party liability, and thus dissuade and disincentivize, the same foreign broker-dealers and stock exchanges that the SEC is presumably trying to attract with its "mutual recognition" initiative. How does the SEC reconcile these incongruous positions?**

ANSWER:

Except as otherwise noted in the supplementary answers at the end of this document, this answer is on behalf of all the Commissioners.

The tripartite mission of the Securities and Exchange Commission is investor protection, maintenance of fair, orderly, and efficient markets and facilitation of capital formation. The two SEC initiatives discussed in your question are intended to serve these goals in a consistent way.

In considering the possibility of selective mutual recognition of selected foreign regulatory regimes, the Commission's objective is to increase U.S. investor choices while preserving robust investor protections. Mutual recognition, done carefully and properly, would enhance the efficiency of markets and capital formation, make U.S. markets more attractive and provide greater investor choice of investments offshore and onshore.

The position recommended by the Commission in *StoneRidge* (unanimously on whether conduct alone can constitute fraud, and on a 3-2 vote (Commissioners Atkins and Casey dissenting) concerning the circumstances under which persons other than the issuer may be considered to have engaged in such conduct) concerns the appropriate interpretation of a civil liability provision and the proper scope of primary liability under the federal securities laws. It was the result of earlier positions the Commission had taken. Imposing liability on those who engage in deceptive practices in connection with the purchase or sale of securities furthers a main purpose of the federal securities laws – insuring honest securities markets and thereby promoting investor confidence. Without the confidence of investors in the integrity of the markets, investors will be less likely to invest, businesses will have less access to their capital, and U.S. markets will be less attractive. While it is the SEC that is primarily charged with policing fraud in the

securities markets, the Commission has long maintained that meritorious private actions are an essential supplement to government actions and serve the interests of investors. When investors feel that their investments are protected against fraud, they will participate in the markets to a greater extent, to the benefit of all market participants, including issuers of securities and market intermediaries.

QUESTION: The general incongruity between the SEC's allegedly pro-"investor protection" approach in *Stoneridge*, and its anticipated, distinctly anti-competitive outcome/result: The SEC's position in *Stoneridge* is ostensibly to "protect investors" by allowing them to sue third parties for the misconduct of the shareholder's company, presumably under the notion that if investors have a wider range of parties they can sue, they are thereby protected. Yet, such an outcome would likely and unnecessarily generate significant additional litigation, cost billions of dollars to American businesses, unjustly enriching an overzealous plaintiff's bar, and putting US companies at a competitive disadvantage to their foreign counterparts. All of these consequences would result in *harm* to investors, to businesses, and to U.S. competitiveness. **Can you explain the analysis that you conducted to determine that, on balances, the arguably marginal benefits to investors in following your recommended approach outweighs the likely harm and costs to investors, businesses, and U.S. competitiveness?**

ANSWER:

Except as otherwise noted in the supplementary answers at the end of this document, this answer is on behalf of all the Commissioners.

In reaching its recommendation in *StoneRidge*, the Commission sought to advance the intent of Congress on the scope of primary liability for a Section 10(b) violation, an intent that, as mentioned in the prior answer, strikes a balance and makes judgments about the importance of civil liability for the protection of investors and the competitiveness of U.S. capital markets. That balance recognizes that some costs will be imposed by methods of enforcement, although the extent of the costs associated with the approach recommended by the Commission in *StoneRidge* is not known.

Mandatory Arbitration

The SEC's silence on the merits of mandatory arbitration despite its own overt actions, tacit support, and ongoing monitoring. In 2002, the SEC commissioned a study by Professor Michael A. Perino (Professor of Law, St. John's University School of Law) on the adequacy of arbitrator conflict disclosure requirements at NASD and NYSE. Professor Perino's report also touched on user perceptions of fairness, finding that "[a]vailable empirical evidence suggests that SRO arbitrations are fair and that investors perceive them to be fair." See M. Perino, Report to the SEC Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Securities Arbitrations (Nov. 4, 2002) available at: http://www.sec.gov/pdf/arbconflict.pdf. **Given (i) the affirmative, pro-arbitration findings in the Perino Report; (ii) the fact the SEC reviews and approves all self-regulatory organization (SRO) arbitration rules and any**

significant changes to the arbitration process; and (iii) the fact the SEC has itself proposed the arbitration of securities class actions; is the SEC satisfied that SRO arbitration programs are generally fair, efficient, and efficacious, and that such programs generally protect investor interests?

ANSWER:

The Federal Arbitration Act established a federal policy favoring arbitration, requiring that the courts rigorously enforce arbitration agreements. This reflects Congress's view that arbitration is a reasonable alternative to litigation. Since 1987, such dispute resolution provisions have become commonplace in the brokerage industry.

As you noted, the Commission's oversight of the securities arbitration process is directed at ensuring that it is fair and efficient – and we believe that generally it is. The Commission oversees the arbitration programs of the self-regulatory organizations, including the NYSE and the NASD, through inspections of the SRO facilities and the review of SRO arbitration rules.[13]

That said, we recognize that, as with most things, there is always room for improvement. In that regard, the Commission and its staff evaluate comments and complaints from the public to help identify areas where improvements can be made in the arbitration process.

With respect to item (iii), there is no proposal before the Commission to allow corporations to mandate arbitration of shareholder claims.

Firm Locate/Pre-Borrow Requirement

- Right now the Commission rules allow a short seller to sell a stock it does not own if it merely has "a reasonable basis to believe that securities can be borrowed in order to make timely delivery." **What does the commission believe the level of commitment or reservation a short seller should have of the security to be sold short before the security is sold?**

ANSWER:

---

[13] Proposed rules are published to give the public notice and an opportunity to comment. Section 19(b)(2) of the Exchange Act requires the Commission to approve a self-regulatory organization rule change if it finds the rule change is consistent with the requirements of the Act. Section 15A(b)(6) of the Act requires the rules of a national securities association to be designed, among other things, to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.

Rule 203(b)(1) of Regulation SHO provides that before a broker or dealer accepts an order to sell short, it must have either borrowed, or arranged to borrow, the security, or have reasonable grounds to believe the security can be borrowed so that it can be delivered on the date delivery is due. This "locate" must be made and documented prior to effecting the short sale. Reasonableness in this context depends on the facts and circumstances of the particular transaction; what is reasonable in one situation may not be reasonable in another. The Commission provided some examples of reasonableness in the Regulation SHO Adopting Release.[14] For example, the Commission stated that while reliance on "easy to borrow" lists generated by stock lenders may be reasonable in some circumstances, such reliance would not be reasonable if securities on the list have experienced delivery failures.

- **What was the Commission's reasoning for not adding the firm locate/pre-borrow requirement to Regulation SHO?**

ANSWER:

The locate requirement of Regulation SHO, together with the rule's delivery requirement, were designed to act as a restriction on naked short selling and extended delivery failures. The narrowly-targeted approach adopted by the Commission was designed to address the problem of large persistent failures to deliver in certain securities while not impeding liquidity or the ability of market participants to establish short positions in securities where delivery failures were not a problem.

Thus, Regulation SHO includes a general locate provision applicable to short sales of all equity securities, requiring that prior to accepting a short sale order, the broker-dealer must have either borrowed, or arranged to borrow, the security, or have reasonable grounds to believe the security can be borrowed so that it can be delivered on the date delivery is due. By contrast, for short sales of securities in which a substantial amount of failures to deliver have occurred (so-called "threshold securities"), Regulation SHO imposes additional delivery obligations, including, in some cases, a pre-borrow requirement. Regulation SHO defines a threshold security generally as an equity security of a registered or reporting issuer for which there is an aggregate fail to deliver position for five consecutive settlement days of 10,000 shares or more that is equal to at least 0.5% of the issue's total shares outstanding.[15] Regulation SHO provides that if a participant of a registered clearing agency has a fail to deliver at a registered clearing agency in a threshold security for thirteen consecutive settlement days, the participant and any broker or dealer for which it clears transactions may not accept or execute a short sale order in the threshold security without borrowing or arranging to borrow the security until the fail-to-deliver position is closed out.[16]

---

[14] See 69 FR 48008, 48014 and notes 58, 61 and 62.

[15] See Rule 203(c)(6).

[16] See Rule 203(b)(iii).

This carefully crafted two-pronged approach thus targets market participants that are directly contributing to the persistent fail-to-deliver position, while not burdening the vast majority of securities where there are not similar concerns regarding settlement.[17] The Commission noted in the Adopting Release that the imposition of a lower threshold might be an overly-broad method of addressing any potential abuses.[18] The approach adopted in Regulation SHO was designed to address potential abuses without unnecessarily impairing liquidity or increasing costs, especially for the overwhelming majority of securities in which delivery failures are not a problem.

- **How does the absence of a firm locate/pre-borrow obligation enable multiple short sellers to trade the same located shares?**

ANSWER:

The purpose of the locate requirement is to decrease failures to deliver. The locate requirement of Rule 203(b)(1) generally prohibits brokers from using the same shares located from the same source for multiple short sales. However, Rule 203(b)(1) does not similarly restrict the sources that provide the locates. We understand that some sources may be providing multiple locates using the same shares to multiple broker-dealers. However, it is our understanding that a large number of locates that are obtained by traders are not ultimately used, and thus no borrowing actually occurs, because for various reasons the trader does not sell short as much stock as it located. Thus, although it is possible for several traders to sell short based on a locate of the same shares from a source, it is much more likely that the number of locates given out by a source will far exceed the number of shares sold short and, consequently, the number of stock loans necessary. It is therefore unlikely that more than one trader will actually trade the same located shares.

- **What is the Commission doing about possible abusive and manipulative trading that could be associated with persistent failures-to-deliver?**

ANSWER:

The Commission and the SROs have closely monitored the operation of Regulation SHO to help ensure compliance by broker-dealers and other market participants with the close-out requirements applicable to those securities with persistent failures to deliver. In addition, the Commission takes any and all allegations of abusive and manipulative trading seriously and pursues them vigorously where warranted. The Commission encourages the public to submit allegations of such conduct to the Commission's Division of Enforcement, which carefully considers any comments it receives.

Regulation SHO Transparency/Disclosure

---

[17] See 69 FR at 48016.

[18] See 69 FR at 48016, n. 85.

- **What level of information does the Commission believe that the average investor should have readily available about the volume of naked short sales and failures-to-deliver in their securities?**

ANSWER:

Currently all self-regulatory organizations (SROs) publish on their websites on a weekly basis a list of all threshold securities that trade on exchanges or markets that they regulate.

On July 14, 2006, the Commission issued proposed amendments to Regulation SHO (the "July 2006 Proposing Release") and sought comment on a number of other issues, including whether it should require the amount or level of fails to deliver in threshold securities to be publicly disclosed. The Commission asked whether requiring information about the amount of failures to deliver would help facilitate prompt delivery, how such disclosure should operate (for example whether such disclosure should be done on an aggregate or individual stock basis), whether providing the investing public with access to aggregate fails data would be useful, and whether providing such data would increase the potential for manipulative short squeezes.

In response to comments the Commission received regarding the July 2006 Proposing Release, including inquiries from various members of Congress, the Commission is considering whether to post on its website aggregate fails to deliver data that the Commission's Office of Economic Analysis receives from the Depository Trust and Clearing Corp. The data would not include confidential broker information and would likely be on a delayed basis.

Elimination of the Option Market Maker Exemption

- The Commission has proposed an amendment to Regulation SHO that will eliminate the option market maker exemption. **When will the language of this amendment be available for public comment? When does the Commission intend to adopt this proposed amendment?**

ANSWER:

As originally adopted, the options market maker exception from Regulation SHO's close-out requirement applied to any failure to deliver in a threshold security resulting from a short sale effected by a registered options market maker to establish or maintain a hedge on an options position created before the security appeared on the threshold list. In adopting the exception, the Commission noted that it would monitor its effect, taking into consideration any indication that the exception was operating significantly differently from the Commission's original expectations.

In the July 2006 Proposing Release, the Commission recommended a modification of the options market maker exception that would require closeout of fail positions when the position being hedged expired or was liquidated. The Commission stated that although Regulation SHO had significantly reduced failures to deliver, it appeared that a small number of threshold securities continued to experience substantial and persistent failures that were not being closed out under existing delivery and settlement guidelines. Examinations by the Staff and the SROs revealed that these persistent fail to deliver positions were attributable in part to reliance on the options market maker exception. The Commission believed a modification of the provision would result in a further reduction of the number of failures to deliver.

Following analysis of comments received in response to the July 2006 Proposing Release, the Commission voted to re-propose amendments to the options market maker exception, recommending that the exception be eliminated, and seeking comment on an alternative, a limited options market maker exception that would require that fail positions resulting from option market makers' hedges be closed out within a certain number of days. The Commission's action was based on a concern that persistent fails to deliver would continue in certain equity securities unless the exception was eliminated. The Commission anticipates that the proposing release on this issue will be published and available for public comment in early August, 2007. Thereafter, the Commission anticipates that the typical rulemaking process will ensue: after considering all comments received in response to the proposing release, the Commission will determine whether to act further, including whether to eliminate or modify the exception. If it decides to do so, the Commission would issue an adopting release incorporating the amendment into Regulation SHO.

Written Questions for the Record
Questions for the Record for the SEC Commissioners
Rep. Kenny Marchant (R-Texas)

Question 1

At the hearing on June 26, 2007, I asked whether the SEC was going to require the disclosure of short positions as well as long positions, in particular by hedge funds. Chairman Cox responded that "[a]nd I just confirmed that, under 13(d), those who are filing under 13(d), the reporting is the same for long and short."

Can the Chairman please clarify and elaborate on that response.

In particular, could you please answer the following questions:

(a) Is the SEC's interpretation of Regulation 13D that when disclosure of a long position is required, the same is true of a short position?
(b) If so, what triggers this disclosure? Is it Regulation 13D or some other statutory or regulatory provision within federal securities law?
(c) Is this different from Commissioner Nazareth's response to my question at the hearings stating that "[w]e don't require reporting on short positions, partly because that information could be used by manipulators – you know, used against people who are holding the short positions?"
(d) Has the SEC or its various offices investigated and discovered situations where entities taking short positions are putting false information into the market to drive the price of a company's stock down and help successfully execute their short strategy? Is this also a policy concern of the SEC? If so, what action has the SEC taken, or is planning to take, to address this issue?
(e) Will the SEC issue a statement clarifying its interpretation or requirements of disclosure for short positions as well as long positions?

ANSWER:

A person who beneficially owns more than 5% of a class of voting equity securities registered with the Commission must report such ownership by filing a Schedule 13D or

13G with the Commission. The definition of "beneficial ownership" adopted by the Commission pursuant to Section 13(d) of the Securities Exchange Act of 1934 "includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares...voting power which includes the power to vote, or to direct the voting of, such security; and/or...investment power which includes the power to dispose, or to direct the disposition of, such security." Exchange Act Rule 13d-3. Investors who enter into short sale arrangements do not obtain the power to vote or dispose of the securities that are the subject of the short sale.

If a person is obligated to file a Schedule 13D, however, then that person must describe, among other things, "the source and the amount of funds or other consideration used or to be used in making the purchases," "any transactions in the class of securities reported on that were effected during the past sixty days or since the most recent filing on Schedule 13D, whichever is less...." and "any contracts, arrangements, understandings or relationships" that the reporting person has with "any person with respect to any securities of the issuer."[19] In addition, a copy of any related written agreement may be required to be filed as an exhibit to the Schedule 13D.[20] These items of Schedule 13D have generally been interpreted—including in a written interpretation publicly disclosed by the staff of the Commission's Division of Corporation Finance—to require disclosure of information about short positions in securities of the issuer of the securities covered by the Schedule.

The staff of the Commission gives careful consideration to the potential implications from the failure to publicly disclose, or the public disclosure of inaccurate or incomplete, material information.. Disclosure of material false information related to short positions in order to impact the price of a security would constitute a violation of the federal securities laws and be of significant concern to the Commission and its staff.

The Commission and its staff continue to monitor whether persons who are required to comply with the federal securities laws would benefit from further guidance as to the interpretation of the Commission's rules and regulations. When deemed necessary, the Commission or its staff issues such public guidance. The Commission and its staff also continue to consider whether the rules and regulations administered by the SEC need to be amended, or whether additional rules and regulations need to be adopted, to address changes in the securities markets.

Question 2

Similarly, for managers who are required to file Form 13F, the SEC does not require that short positions be disclosed. Reporting is limited to long positions. This seems again to not only call for an explanation, but it permits managers to make misleading disclosures in which the SEC and the public are misled about a manager's true stance with respect to a particular issuer.

---

19 See Items 3, 5 and 6, Schedule 13D.

20 See Item 7, Schedule 13D.

(a) What is the basis of the SEC's policy of not requiring disclosure of short positions on Form 13F?
(b) Is there any reason why such equal disclosure should not be required?
(c) Is new regulation required to mandate such disclosure, or is the limitation of disclosure to long positions a matter of agency interpretation?

ANSWER:

Section 13(f)(1) of the Exchange Act requires certain institutional investment managers to file reports with the Commission disclosing information "for each such equity security *held* by accounts with respect to which the institutional investment manager exercises investment discretion." A person has a short position in a security when it sells a security that it does not own; a person with a short position therefore does not *hold* the security which is subject to a short sale. Thus, consistent with the plain meaning of the wording of Section 13(f)(1), the Commission has stated that the Section 13(f)(1) filing requirement relates solely to an institutional manager's long positions.[21] Further, because of the emphasis in the statute on *holdings*, the Commission also has stated that "additional legislative authority may be necessary or appropriate to require public reporting of short positions ... for market information purposes."[22]

You raise a concern that information disclosed on Form 13F will mislead the Commission and the public as to a manager's "true stance with respect to a particular issuer." While the positions reported on Form 13F might not reflect a manager's net position in any particular issuer, we believe that the information reported is not materially misleading. Form 13F is a holdings report. The cover page of the form requires a manager to disclose in a check-the-box format whether all of its *holdings* are reported in the Form 13F report and whether the filing reflects new *holdings entries* of the manager. Accordingly, we believe that persons should not be misled into believing that a manager's net position in any particular security is disclosed on the form.

In addition, you ask whether there is any reason why disclosure of short positions should not also be required. In considering whether to require such disclosure, one should take into account the nature of short selling. Based on our understanding that many short positions are opened and closed relatively quickly due to the cost and risk of maintaining an open short position, a manager's Form 13F filings would disclose only those short

---

21 See Public Disclosure of Material Short Security Positions, Securities Exchange Act Release No. 29278 (June 7, 1991) ("Section [ ] ... 13(f) .... require[s] public reporting of material long (but not short) positions.").

22 *Id.* at text immediately preceding and following n.58.

positions open on the last trading day of each calendar quarter. Thus, there is the possibility that a significant percentage of a manager's short positions might not appear on Form 13F because the manager's positions were opened and closed before the reporting date. An important consideration for the Commission is the value of the information about a manager's short positions versus the possible detrimental effects of such disclosure on a manager's ability to implement its investment strategy and the financial interest of the manager's clients.

Question 3

With regard to Regulation SHO, can you explain to me why the Options Market Maker exception to Regulation SHO's requirements is necessary? Has the SEC looked into whether that exception has been abused by any market participants to avoid complying with the procedures required by Regulation SHO?

ANSWER:

The options market maker exception from Regulation SHO's close-out requirement applies generally to any failure to deliver in a threshold security resulting from a short sale effected by a registered options market maker to establish or maintain a hedge on options positions created before the security appeared on the threshold list. The options market maker exception was included in Regulation SHO to address concerns regarding liquidity and the pricing of options. In commenting on Regulation SHO at the proposing stage, certain options market makers had advised the Commission that if such a hedging exception were not included, options trading in securities that are difficult to borrow would cease altogether because no options market maker would make markets without the ability to hedge by selling short the underlying security. In adopting the options market maker exception, however, the Commission noted that it would monitor its effect, taking into consideration any indication that the exception was operating significantly differently from the Commission's original expectations.

In the July 2006 Proposing Release, the Commission proposed a modification of the options market maker exception that would require, in general, that fail positions be subject to close out when the position being hedged expired or was liquidated. The Commission, together with the SROs, monitored operation of the options market maker exception. Examinations by the Staff and the SROs revealed that a small number of threshold securities continued to experience substantial and persistent failures that were attributable in part to reliance on the options market maker exception. The Commission believed that the proposed modification of the options market maker exception would further reduce the number of failures to deliver.

Following analysis of comments received in response to the July 2006 Proposing Release, the Commission voted on June 13, 2007 to re-propose amendments to the options market maker exception, recommending that the exception be eliminated, and seeking comment on alternatives, a limited market maker exception that would require that fails to deliver in threshold securities underlying options be closed out within

specific time-frames. The Commission stated its concern that if changes were not made, persistent fails to deliver would continue in certain equity securities. In addition, during the July 2006 Proposing Release comment process, it became apparent to the Commission that the language of the current options market maker exception was being interpreted more broadly than the Commission intended, such that the exception appeared to be operating significantly differently from the Commission's original expectations. Moreover, options market makers had expressed concerns that it would be difficult to comply with the proposed close-out provision, which would have required the close out of any fail position associated with an options position when that position expired or was liquidated, because they hedge on a portfolio basis, rather than position-by-position.

Based on commenters' concerns that they would be unable to comply with the proposed amendments, and statements indicating that options market makers might be violating the current exception, the Commission decided instead to propose that the exception be eliminated, or alternatively, that a limited exception as described above be adopted. The Commission preliminarily believes that any potential negative effect on options market liquidity and pricing would be minimal and outweighed by the benefits resulting from a further reduction in the number of persistent failures to deliver.

Question 4

I hear that there are dishonest analysts in the marketplace who claim to be "independent," yet put out inaccurate or false reports or fail to disclose that they have close ties with or receive fees from parties with an interest in their reports. I don't know if this is true.

As you know, Section 17(b) of the Securities Act of 1933 is addressed to paid statements by any person concerning securities. By its terms, it requires disclosure of payments made by "an issuer, underwriter, or dealer." As defined by the Securities Act, an issuer is "any person who issues or proposes to issue any security" and a dealer is "any person who engages either for all or part of his time, directly or indirectly as agent, broker, or principal, in the offering, buying, selling, or otherwise dealing or trading in securities issued by another person."

Given these broad definitions – in your view – could you please answer the following questions:

(a) Does Section 17(b) apply to payments made by hedge funds or others to "independent" securities analysts to draft and circulate a report or analysis on a particular security without the public or investors knowing?

(1) If Section 17(b) does apply, what action has the SEC undertaken to enforce 17(b) in this context?

(2) If Section 17(b) does not apply, what adjustments to the applicable regulatory scheme may be needed, or what action does Congress need to take, to address this issue?

ANSWER:

As you note, Section 17(b) of the Securities Act of 1933 requires analysts to disclose payments by issuers, underwriters, or dealers. A payment from a hedge fund would not necessarily implicate Section 17(b), unless the hedge fund was acting as an issuer, underwriter or dealer in connection with the securities that were the subject of the publication.

Nevertheless, the conduct described in the hypothetical, *i.e.*, analysts who claim to be "independent" issuing reports based on fees or other remuneration from hedge fund advisers without disclosing the fees or other remuneration, could potentially violate other federal securities laws, such as the anti-fraud provisions (Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder, as well as Section 17(a) of the Securities Act of 1933). In addition, this conduct could violate Regulation Analyst Certification (Reg AC) for those analysts who are broker-dealers or affiliated persons.

Question 5

There have also been reports that certain influential hedge funds have been provided with advance information concerning forthcoming reports and ratings by major securities analysts.

(a) Is there any truth to these reports?

(b) If so, is the selective advance disclosure of such reports and ratings prohibited by existing law?

(c) Is advance trading on such information prohibited?

(d) What is the SEC doing to monitor such situations?

ANSWER:

We are aware that, in some instances, individuals may have obtained information concerning forthcoming analyst reports and ratings, and may have traded on such nonpublic information in violation of the federal securities laws. For example, in March

2007, the Commission filed an action, *SEC v. Guttenberg*, charging several individuals, including hedge fund traders, with violations of the insider trading prohibitions of the federal securities laws based on trading on material non-public information about forthcoming analyst reports from employees of large broker-dealers.[23] The Commission's complaint alleges that the employees of the firms who provided the advance information about the analyst reports and ratings did so in violation of a fiduciary duty to their employers not to divulge such information. The Commission continues to monitor the marketplace for insider trading violations, including those based on material, non-public information concerning forthcoming analyst reports and ratings.

Question 6

I understand that the SEC has been working on amending Regulation SHO in order to make it more effective in preventing chronic and improper failures to deliver securities, and I commend that effort. However, it seems that there still seems to be an unwillingness on the part of the SEC to fully and promptly disclose to issuers and the markets information and data concerning failures to deliver that is already in the SEC's possession.

(a) Why should the aggregate fails to deliver for each security on the Threshold List not be disclosed on a daily or weekly basis?

(b) Do you think that beyond that aggregate data, it would be possible to identify publicly the causes of chronic failures to deliver?

ANSWER:

(a) Currently, all SROs publish on their websites on a weekly basis a list of all threshold securities that trade on exchanges or markets that they regulate. The July 2006 Proposing Release sought comment on whether we should require the amount or level of fails to deliver in threshold securities to be publicly disclosed. The Commission asked whether requiring information about the amount of failures to deliver would help facilitate prompt delivery, how such disclosure should work (for example whether such disclosure should be done on an aggregate or individual stock basis), whether providing the investing public with access to aggregate fails data would be useful, and whether providing such data would increase the potential for manipulative short squeezes.

In response to comments the Commission received regarding the July 2006 Proposing Release, including inquiries from various members of Congress, the Commission is considering whether to post on its website aggregate fails to deliver data that the Commission's Office of Economic Analysis receives from the Depository Trust and Clearing Corp. The data would not include confidential broker information and would likely be on a delayed basis.

---

[23] A copy of the complaint in this matter is available on the SEC's website at: http://www.sec.gov/litigation/complaints/2007/comp20022.pdf

(b) There may be many legitimate reasons for a failure to deliver. For example, human or mechanical errors or processing delays can result from transferring securities in physical certificate rather than book-entry form, thus causing a failure to deliver on a long sale within the normal three-day settlement period. A fail may also result from legitimate naked short selling by market makers in response to customer demand in a thinly traded, illiquid stock. Regulation SHO is designed to address the problem of extended failures to deliver by providing mandatory close-out procedures. The causes of the failures to deliver are not necessarily investigated or determined in every case, unless, of course, they appear to be the result of manipulation. In some cases, the fact that manipulation caused extended delivery failures may be disclosed if it results in Commission action.

Question 7

Does the SEC plan to hold hearings on the oversight of hedge funds in the future?

ANSWER:

While we are not planning any roundtables, the Commission is very involved in the President's Working Group process and we believe that this effort, which includes the Treasury Department, Federal Reserve, and Commodity Futures Trading Commission as well as the SEC, is currently the appropriate place to address issues concerning the response of U.S. financial regulation to the challenges posed by hedge funds. In this vein, we are also very involved in a joint regulatory project including the Federal Reserve and United Kingdom Financial Services Authority, as well as other U.S. and European regulators, intended to improve our collective understanding of the potential systemic risks that hedge funds pose to the broad financial system through their interactions with commercial banks and securities firms, including the five internationally active U.S. securities firms – Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley – supervised by the Commission on a consolidated basis. This project has provided, and continues to provide, significant insights that inform the broader President's Working Group process.

Supplementary Answers

Joint Response by Commissioners Roel C. Campos and Annette L. Nazareth to Questions Submitted by Representative Al Green of Texas*

Enforcement Policy

Under the new policy governing monetary penalties in enforcement actions against public companies, the SEC staff would be required to obtain Commission approval before engaging in negotiations for settlements.

- Can each Commissioner tell me whether you think that replacing the independent judgment of professional SEC staff with a decision influenced by political appointees will result in politicization of the enforcement process?

We certainly would not support the politicization of the enforcement process, and we do not believe that the pilot program is designed to inappropriately influence the professional judgment of the staff. We have great respect for the career professionals at the SEC. We take their counsel and recommendations very seriously and consider them carefully before making a decision in a case. Ultimately, as Commissioners, though, we are the ones who must vote on whether to approve the recommendation, so we each must make our own determination about what we think is appropriate under the circumstances of any individual case. That is the same determination that we had to make before this pilot program was implemented and is the same determination that we have to make in all other cases before the Commission.

Under the pilot program, the staff will come to the Commission with its recommended settlement range, which can include injunctive and monetary relief, and the Commission and staff will have the opportunity to discuss the proposal fully prior to a Commission vote on approving a settlement range. If the staff then negotiates a settlement that falls within that range, the process for Commission approval of the settlement is streamlined and expedited. In cases not involving penalties against public companies, the staff has the opportunity to assess many details of the case during the settlement negotiation process. The final settlement recommendation has the benefit of the learning derived from this process. As a result we are somewhat concerned that the pilot approach will provide recommendations to the Commission that are not as fully developed as was previously the case. Thus, we have put a great deal of emphasis on the need to carefully monitor the pilot to assure its objectives are met.

- Chairman Cox has stated that the new policy would give staff more "negotiating leverage." Can each Commissioner tell me whether you believe that this increased "negotiating leverage" will result in increased investor protection or will it result in lower monetary penalties on public companies?

* The Commissioners' responses are shown in italics.

We do not agree that the new policy will give the staff more "negotiating leverage." It was extremely rare for the Commission to reject a settlement recommendation of the staff, and therefore the staff's negotiating leverage did not appear to be at issue. That having been said, it is too soon to tell what the actual impact of the new policy will be on the size of monetary penalties against corporate issuers. We are interested in seeing this data as it develops and comparing it with prior years.

We do not view the size of a monetary penalty as the sole measure of investor protection. Each penalty determination is based on the individual facts and circumstances of the case before the Commission and the staff. There may be cases in which investor protection is best served by remedies other than monetary penalties or in which the Commission's penalty factors guide us to a small or moderate penalty rather than a large penalty. We are very mindful of the Commission's investor protection mission and encourage the staff to use all of the tools available in these cases to craft settlements that best serve that mission.

One reason given for this new SEC policy is that it will result in "more productive and fast-tracked negotiations." Under the new policy, supporters argue, the Commissioners will be on the same page with the SEC staff prior to a settlement being negotiated.

- Can the Commissioners tell me what the problems were, and the extent to which those problems existed, with the previous policy such that this change in policy was necessary? Were there complaints of inadequate investor protection? Do you think the benefits of streamlining the process and having more speedy outcomes is worth the risks that may result from changing the current system?

We do not believe that there were problems with the previous procedure, and we note that the prior procedure remains in place for all settlements that do not involve corporate issuers. We are not aware of any complaints of inadequate investor protection under the previous procedure. The new policy is a pilot program that will apply to a small subset of cases. We are certainly willing to try the new program, with careful monitoring, to see if it in fact results in more productive negotiations and a more efficient approval process, consistent with investor protection. If it does not, though, we would favor terminating the pilot program.

- Can you tell me how often the Commission sent the enforcement unit back to the drawing board to renegotiate a settlement under the current policy?

While we do not know the exact numbers, in our experience it has been extremely rare for the Commission to ask the staff to go back to a defendant with a different settlement proposal.

- Is there something inherently wrong or harmful with having the process as it existed before, where the Commissioners served as an "appeals court" rather than a trier of fact? Isn't this a more effective way for the

Commission to communicate its policy views to the staff, rather than on a case-by-case basis?

We do not think that there was a particular problem with the prior settlement process, and that process remains in effect for the vast majority of the Commission's cases. However, we are open to suggestions about ways in which to improve the process and are amenable to trying this pilot to see if it in fact helps streamline the issuer penalty negotiation and approval process. We do not think that the "appeals court" / "trier of fact" distinction analogy is entirely on point here. In the context of settlement discussions, we do not view the Commission as either an appeals court or a trier of fact. Rather, the Commission considers the staff's recommendation and discusses it with the staff members who have investigated the case and are most familiar with it. Under the pilot program, this discussion will occur earlier in the process than before, but it is still a discussion based on the recommendations of the staff who investigated the case.

The Commission's policy views can be communicated to the staff in a number of different ways, including in the discussion of a particular case. We believe it is important for the Commission to provide clear guidance to the staff so that the staff is not left to guess how the Commissioners view certain types of cases and issues. While we do not think that the Commission should engage in rule-making through its enforcement actions, the discussions between the Commission and the staff in the closed Commission meetings about particular enforcement cases can provide useful input to the Commission and feedback to the staff about relevant policy issues.

One of my concerns regarding this new policy is that the Commissioners will be making or helping make recommendations without having the case fully-developed. Under the current process, SEC staff typically will bring enforcement recommendations to the Commission based on 2 scenarios. In the first scenario, the staff brings the proposed settlement (to which the defendant has already agreed) supported by a lengthy staff memorandum describing the evidence and legal issues in the case and recommending that the Commission authorize the settlement. In the second scenario, the SEC staff will bring a recommendation that a "non-settled" enforcement action be authorized (i.e. the defendant has not agreed on the enforcement action) supported by a staff memorandum and accompanied by a "Wells" submission from the defendant setting forth the reasons why the staff's recommendation should be rejected or narrowed.

- In both scenarios, enforcement recommendations have reached the Commission in a fully-developed state. Under the new policy, the Commission will be recommending decisions without the benefit of the give-and-take of settlement negotiations or without the defendant having the opportunity to be heard via a Wells submission. <u>This is similar to having a judge render a verdict without the benefit of hearing both the plaintiff and defendant argue their sides of the case.</u> Can the Commissioners tell me whether they believe that this new policy will adversely affect the quality of the Commission decisions?
- Who is in a better position to determine a proper outcome in these cases, a Commissioner who reviews a case after a negotiated settlement has been reached (or in the alternative, after reading the SEC staff's

recommendation and the defendant's "Wells" submission) or a Commissioner who does not have the benefit of this intelligence?

- Under the new policy, is it possible to develop a mechanism by which the Commissioners could hear the arguments of both the SEC staff and the defendant? One approach that has been suggested is for the SEC staff to inform defense counsel that the staff is going to the Commissioners and to allow for staff-defense counsel meetings and memoranda similar to a "Wells" submission. Couldn't this process result in unnecessary expense for corporations that they would have to incur before they even enter into settlement negotiations? In other words, under the current policy, only corporations that did not reach settlement would have to pay that expense, while under this proposed solution to the new policy, all corporations would have to pay that expense, even those that would eventually choose to reach settlement.

We share your concern about making decisions in the absence of complete information. We think it will be important for the staff to have developed the case as much as possible prior to making a settlement range recommendation to the Commission. One purpose of authorizing a range of settlement options is to provide the staff with the flexibility to react to developments and information during the settlement negotiations while knowing that a settlement within the approved range is acceptable to the Commission. Additionally, should the negotiation result in information that leads the staff to conclude that the approved range is not appropriate, the staff has the ability to (and should) come back to the Commission with this new information and any revisions to its recommendation as a result of that information. In such situations, no efficiencies would be gained.

With careful monitoring, we do not anticipate that the pilot program will adversely affect the quality of Commission decision-making, and if we should perceive that to be occurring, we would not hesitate to suggest that the pilot be altered or discontinued. Under the pilot program, companies are permitted to provide submissions to the staff for consideration by the Commission in our discussions regarding settlement authorizations. We will certainly consider any submissions that we have received from the company in deciding to authorize a particular settlement range. If we find that we have insufficient information to approve a particular range of settlement options at the time that the staff seeks settlement authority, we would express that opinion and ask for additional information.

We will have to monitor the pilot program very carefully to ensure that it indeed leads to more productive negotiations and a more efficient approval process. Among other things, we will need to monitor feedback from the staff and defense counsel on their experience with this new process, as well as data on the timeliness of settlements, to determine whether the new policy is achieving its desired goals.

○