

FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2008

WEDNESDAY, MAY 16, 2007

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

The subcommittee met at 3:07 p.m., in room SD-192, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.

Present: Senators Durbin, Brownback, and Allard.

SECURITIES AND EXCHANGE COMMISSION

STATEMENT OF HON. CHRISTOPHER COX, CHAIRMAN

STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. Good afternoon. This hearing will come to order.

I am pleased to convene this session before the Financial Services and General Government Appropriations Subcommittee. Our focus today is on the President's fiscal year 2008 budget request for the Securities and Exchange Commission (SEC). In previous years funding for this agency was provided through the Commerce, Justice, and State, the Judiciary Subcommittee. It now has a new home in the Senate Financial Services Subcommittee.

I welcome my colleague Senator Allard who has joined me and others who may arrive. Appearing before the subcommittee this afternoon is the Chairman of the SEC, the Honorable Chris Cox. Welcome, Chairman Cox. Glad to have you here, my former colleague from the House.

The mission of the SEC is to administer and enforce Federal securities laws, to protect investors, and maintain fair, honest, and efficient markets. This includes ensuring full disclosure of financial information, regulating the Nation's security markets, and preventing and policing fraud and malpractice in the securities and financial markets.

The administration's budget proposal for fiscal year 2008 seeks \$905.3 million for the SEC. This is a 2.7-percent increase, \$23.7 million over the fiscal year 2007 spending level. The \$905.3 million includes \$30.3 million in carryover balances.

It is interesting and important to note that the entire amount of the SEC budget authority is derived from the collection of fees, fees that are collected and deposited in special offset accounts, available

to appropriators, not to the Treasury's general fund. As a result of these fee collections, no direct appropriations are used to fund the SEC.

The proposed funding level of \$905.3 million is similarly structured: \$648.5 million designated for enforcement, \$59.4 million for regulatory function, \$126 million directed to disclosure reviews and investor education, and \$71.4 million for operations.

I would like to invite my colleague Senator Allard, if he would like, to make an opening remark at this point.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Mr. Chairman, thank you. I would like to make a brief remark if I might. I want to thank you for holding this hearing.

Currently the securities and financial markets of the United States are thriving and investors are enjoying the longest bull run in over 80 years. The Dow Jones Industrial Average has recorded 22 record closes since the start of the year and the S&P 500 is 24 points below its record close it set in March 2000. The Dow is no longer showing lingering effects of the 416-point drop it suffered on February 27 and the U.S. economy is continuing to expand and is adding jobs.

With more than one-half of American families investing in the securities market, it is vital to our Nation's economic health that we enjoy fairness, integrity, and efficiency in the marketplace.

I would like to take this time to welcome my good friend and former colleague, Chairman Cox, whose responsibility it is to uphold the SEC's mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. I am used to seeing Chairman Cox testify before the full Senate Banking Committee, but I welcome him here and this opportunity to discuss important issues involving the SEC.

We will be holding a hearing tomorrow, Mr. Chairman, in the authorizing committee on the consolidation of the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE) regulatory functions. I would like to thank you, Chairman Cox, for allowing a member of the SEC to testify in front of that committee on this matter.

Again, Mr. Chairman, thank you for holding today's hearing. I look forward to hearing Chairman Cox's testimony and working with him and the SEC as a member of this subcommittee and as the ranking member of the Securities and Insurance and Investment Subcommittee.

Thank you, Mr. Chairman.

Senator DURBIN. Thank you, Senator Allard.

I want to just join in noting that the stock market has been doing very well and I hope there is nothing we will do here today that will change that.

I turn now to Chairman Cox for your presentation. Welcome, Mr. Chairman.

SUMMARY STATEMENT OF CHRISTOPHER COX

Mr. COX. Thank you very much, Chairman Durbin. I know that Ranking Member Brownback will perhaps be here soon. Senator

Allard. It is a pleasure to testify before you today. Thank you for giving me this opportunity to engage in some sharing of information about our budget request for fiscal 2008.

Before I begin, I would like to congratulate you, Mr. Chairman, on assuming this new role. I am very, very pleased and looking forward to working with you.

As you know, we are requesting \$905.3 million for the SEC in 2008, and that represents an increase, as you noted, Mr. Chairman, over fiscal year 2007 that will allow the SEC to continue the important initiatives underway to protect and inform investors. These initiatives all have in common that they are aimed at benefiting the average retail customer, whose savings are dependent on healthy and well-functioning markets.

Since I became Chairman I have worked to reinvigorate the agency's focus on the ordinary investor. This is the SEC's traditional responsibility. Back in Joe Kennedy's day, our first SEC Chairman could marvel that 1 in 10 Americans owned stocks. Today one-half of Americans own securities, and the median income for shareholders is a very middle class \$65,000.

When you then consider all the teachers, the Government employees, and the workers in other industries who have pensions, it becomes clear that nearly all taxpayers have a personal interest in fair and honest securities markets. In fact, when one considers the staggering growth in Americans' participation in the market, the enormity of the SEC's task becomes apparent. About 3,600 staff at the SEC are responsible for overseeing over 10,000 public companies, investment advisers that manage over \$32 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.

These daunting numbers make it clear that, even if the SEC budget were to double or to triple, the agency would have to carefully set priorities. That is exactly what we are doing in our proposed budget for fiscal 2008.

Our risk-based and flexible approach to our examination program is permitting us to focus the agency's energies on the particular marketplace practices that are most likely to be high risk and on the particular investment advisers and mutual funds that are most likely to be sources of trouble. It also provides the basis for the selection of targets for comprehensive exam sweeps on crosscutting issues that could present a significant threat to investors, and it drives the SEC's enforcement, rulemaking, and disclosure reviews as well. In each case, the objective is to apply the taxpayers' resources in ways that make the most significant positive contribution to investor protection.

If I may, Mr. Chairman, I would like to point out some of the major areas in which the SEC is currently focusing its energies. Our most important initiatives begin with our focus on fighting fraud against seniors. There are an estimated 75 million Americans who will turn 60 over the next 20 years, and they are going to live longer than any generation before them. As the baby boomers turn 60, that is 10,000 of them every day for the next 20 years, they will need to continue to actively manage their investments for higher

yield over their longer lifetimes. It was not that way with their parents.

Rather than switching into low-yield safe investments as their parents did, they are going to have to be active managers overseeing their returns to provide for a much longer lifetime. That is going to have enormous consequences for our capital markets.

Households today led by people over 40 already own 91 percent of America's net worth; and, as the baby boomers retire, very quickly the vast majority of our Nation's net worth will be in the hands of our Nation's seniors. So following the Willie Sutton principle, scam artists are going to swarm like locusts over this increasingly vulnerable group because that is where the money is.

Nearly every day, the SEC 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 and why we have organized our fellow regulators and law enforcement officials at the first-ever national senior summit, here in Washington last July. This year's summit, the second annual, will integrate even more of our national resources, and it will take place in just a few months with our partners.

We have developed a strategy to attack the problem from all angles. It includes aggressive enforcement, targeted examinations, and, very importantly, investor education. Over the past year the SEC's Division of Enforcement has brought 26 enforcement actions specifically aimed at protecting elderly investors. Many of those were coordinated with State authorities.

For example, the Commission coordinated with law enforcement authorities in California to crack down on a \$145 million Ponzi scheme that lured elderly victims, elderly would-be investors, into workshops with the promise of free food and then bilked them out of their retirement money by purporting to sell them safe guaranteed notes. In another case we filed an emergency action to halt an ongoing securities fraud that targeted individuals' retirement funds.

By focusing on free lunch seminars and dozens of other techniques that would-be fraudsters aim at seniors, the Federal Government is serving notice that there will be a special place in hell reserved for those who prey on the life savings of older Americans.

Another important focus for the Commission is a program I know that is of significant interest to you, Mr. Chairman, and that is the agency's Office of Global Security Risk. As you know, this office, which is located in the Division of Corporation Finance, is responsible for monitoring companies' disclosures regarding their contacts with countries that have been identified by the State Department as State sponsors of terrorism and for coordinating with other Federal Government agencies to ensure the sharing of information that is relevant to that assessment.

The office reviews Securities Act registration statements and Exchange Act filings whenever it appears that a company may have material contacts with countries that raise global security concerns, and it requires enhanced disclosure where appropriate.

In the past year, the office issued comments to approximately 212 companies. The office conducts reviews both independently and in concert with the rest of the division's disclosure review staff. In

reviewing companies' disclosures, the office draws upon a variety of data sources. It also coordinates with the Treasury's Office of Foreign Assets Control and Commerce's Bureau of Industry and Security.

I appreciate the leadership of this subcommittee in ensuring that investors have the relevant information that they need to make informed investment decisions regarding the foreign activities of companies that they own, and I am confident that the Office of Global Security Risk is well positioned to continue fulfilling these vitally important responsibilities.

Another priority for the Commission is ensuring that the money that is recovered in SEC settlements and court cases is distributed as quickly as possible to injured investors. The Sarbanes-Oxley Act in 2002 gave the SEC this new "fair funds" authority. Since then we have begun to develop a very considerable expertise in this area. When I became Chairman in 2005, the SEC had completed the process of disbursing funds to investors in only a few cases. Since then we have returned over \$1.7 billion in penalties and disgorgements to injured investors in significant cases, including WorldCom, Global Analysts Research, New York Stock Exchange Specialists, Hartford, and Bristol-Myers-Squibb.

In addition, several large disbursements are pending and will be announced very shortly.

To completely fulfill the vision that Congress wrote into Sarbanes-Oxley, however, will require a sustained effort to train professionals in this area. That is why I have ordered the creation of a new office that will work full time to return these funds to investors. The efforts of this new office will be aided by a new information system called Phoenix, that will more accurately track, collect, and distribute the billions of dollars in penalties and disgorgements that flow from our enforcement work. The efficiency of a dedicated tracking system will remove what has been a major hindrance in our efforts to quickly distribute fair funds.

Another major initiative I want to bring to your attention holds great potential for investors. It is called interactive data. By using interactive data, we can give investors far more information in a far more useful form than anything they have ever gotten from the SEC before. In the very near future, investors will be able to easily search through and make sense of the mountains of financial data contained in current company disclosures.

We are going to convert the SEC's current online system, called EDGAR (electronic data gathering analysis and retrieval system), from what is really now just a vast electronic filing cabinet into something that is truly interactive, a tool that lets an investor, an analyst, anyone, manage all of that information in ways that are truly useful to them. With a few clicks of the mouse, investors will be able to find, for example, the mutual funds with the lowest expense ratios, the companies within a particular industry that have the highest net income, or the overall trend in their favorite company's earnings.

To take advantage of the capabilities of interactive data, the SEC is modernizing the entire EDGAR system; and, as part of this effort, the very new and different EDGAR will be renamed later in 2007. It came as a bit of a shock to viewers of the hit TV show "24"

when Edgar bit the dust and it may take a while for people to get used to the new, improved EDGAR with a new name, but the effort will be supremely worthwhile.

In all, the Commission is investing \$54 million over several years to build the infrastructure to support widespread adoption of interactive data.

Finally, I want to discuss a significant new responsibility that the SEC is undertaking this year to oversee credit rating agencies. As you know, in 2006 the Congress gave the SEC this new responsibility and new authority to register and inspect the Nation's credit rating agencies, including industry giants Standard and Poor's, Moody's, Fitch Ratings, and A.M. Best, as well as several other large, medium, and smaller current and potential industry participants.

Because of congressional concern that the industry faces potential conflicts of interest, imposes barriers to entry for new rating agencies, and has failed to warn the market of such significant impending financial failures as Enron and WorldCom, even immediately before their collapse, the SEC is tasked with devoting significant manpower and resources to this area. Under the new law and the SEC's proposed implementing rules, credit rating agencies will be required to register with the Commission. In addition, they will be required to submit to periodic inspections to ensure that they are implementing policies to mitigate conflicts of interest, prevent leaks of material nonpublic information, and to refrain from coercive or unfair practices.

The SEC takes this new responsibility very seriously. We remain committed to finalizing the new rules before the statutory deadline, and we are assembling a team of staff to oversee the program and begin conducting inspections over the next several months.

So with that background, Mr. Chairman, that brings us to our requested budget increase for fiscal 2008. That level will permit us to continue our ongoing hiring to reach a level of approximately 3,600 full-time staff. This level of personnel strength, which as you know is 21 percent higher than in 2001, will permit the agency to vigorously pursue its mission and maintain strong regulatory, enforcement, examination, and disclosure review functions. It will also allow the SEC to continue our commitment to information technology.

In addition to the SEC's interactive data initiative, the SEC is deploying new systems to better manage enforcement and examination programs. We are using new techniques and new technology to help make our existing staff more productive. There is absolutely no question that these technology improvements will make the SEC more productive and give investors and taxpayers more value for the money.

Over the last 2 years, the SEC has made tremendous progress in improving its operations. This fiscal 2008 request will permit us to continue improving the agency's internal financial controls. The SEC has poured tremendous energy into this area since I have been Chairman. As you know, a few years before I joined the SEC, the agency began to publish audited financial statements. I am pleased to report that for the first time in its history the SEC last year received a clean opinion of its audited financial statements for

2006, with no material weaknesses in internal controls. That is vitally important, Mr. Chairman, because the SEC must set an example not only for other Federal agencies, but also for the many public companies whose financial statements and disclosures we review.

For this reason, we plan to continue upgrading the agency's financial system and to beef up security over our information security.

The largest single application of our requested budget increase will be to fund pay raises for SEC staff that will average between 5 percent and 6 percent next year. These healthy increases are in accordance with the SEC's pay parity authority and our collective bargaining agreement. I should point out, Mr. Chairman, the fact that cost-of-living adjustments, career ladder promotions, and merit pay increases that are essentially built into our system amount to between 5 and 6 percent each year. That is a challenge for the SEC and for this subcommittee because two-thirds of our budget is personnel; and, if two-thirds of our budget is growing each year automatically by as much as 6 percent, then the agency's total budget has to increase by 4 percent just to maintain personnel at a steady state from year to year.

The final and most important reason that the SEC needs the budget increase that we are requesting is to provide the tools that we need to address emerging risks in the Nation's capital markets, including not just known areas of concern, such as hedge fund insider trading, the safety and security of 401(k) plans, and fraud in the municipal securities market, but also threats to market integrity and investor confidence that have yet to emerge.

PREPARED STATEMENT

So I appreciate, Mr. Chairman, the opportunity to discuss with you the SEC appropriation for fiscal 2008. I look forward to working with the subcommittee on the best ways to meet the needs of our Nation's investors. I would be happy to take your questions.

Senator DURBIN. Thank you very much, Chairman Cox.
[The statement follows:]

PREPARED STATEMENT OF CHRISTOPHER COX

Chairman Durbin, Ranking Member Brownback, and Members of the Subcommittee: Thank you for the opportunity to testify today about the Securities and Exchange Commission's budget request for fiscal year 2008.

Before I begin, I would like to congratulate you, Mr. Chairman, on your new role as head of this subcommittee. I look forward to working with you and all the members of this subcommittee for the benefit of the nation's investors.

As you know, the President's budget requests \$905.3 million for the SEC in 2008. I fully support this request for increased funding over fiscal year 2007, which will allow the SEC to continue the important initiatives underway to protect and assist the average investor.

These initiatives all have in common that they are aimed at benefiting the average retail customer whose savings are dependent on healthy, well-functioning markets. Since I became Chairman, I have worked to reinvigorate the agency's focus on the ordinary investor. 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, and the median income for shareholders is a very middle-class \$65,000. When you then consider all of the teachers, government employees, and workers in other industries who have pensions, it becomes clear that nearly all taxpayers have a personal interest in fair and honest securities markets.

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, investment advisers that manage more than \$32 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.

These daunting numbers make it clear that, even if the SEC budget were to double or triple, the agency would have to carefully set priorities. That is exactly what we are doing in this proposed budget for fiscal year 2008. We must continue to think strategically about which areas of the market pose the greatest risk, and which areas of potential improvement hold the greatest benefit for investors. And given the fast changing conditions in America's and the world's capital markets, we must remain agile and flexible enough to redirect our resources with little notice.

This risk-based and flexible approach guides the SEC's examination program as we focus the agency's energies on those practices in the marketplace, and those investment advisers and mutual funds, that are most likely to be high-risk. It also provides the basis for the selection of targets for comprehensive examination sweeps on cross-cutting issues that could present a significant threat to investors. And it drives the SEC's enforcement, rulemaking, and disclosure review functions as well. In each case, the objective is to apply the taxpayer's resources in ways that provide the biggest investor protection bang for the buck.

In recent years, the SEC has professionalized the culture of risk assessment that informs so many of our programs throughout the SEC. From relatively modest beginnings as a discrete office within the SEC established by my predecessor, William Donaldson, the risk assessment function is now wholeheartedly embraced in every major functional division and office of the agency.

If I may, Mr. Chairman, I would now like to discuss some of the major areas in which the SEC is currently focusing its energies, in order to provide the maximum benefit to America's retail investors.

FIGHTING FRAUD AGAINST SENIORS

As you know, an estimated 75 million Americans will turn 60 over the next 20 years. And they will live longer than any generation before them. As the Baby Boomers turn 60—more than 10,000 of them every day for the next 20 years—they will need to continue to actively manage their investments for higher yield over their longer lifetimes, rather than switching into low-yield, safe investments as their parents did. This will have enormous consequences for our capital markets. Households led by people aged 40 or over already own 91 percent of America's net worth. The impending retirement of the baby boomers will mean that, 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 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, and why we organized our fellow regulators and law enforcement officials at the first-ever Seniors Summit in July 2006. This year's Seniors Summit, which will integrate even more of our national resources, will take place in just a few months. With our partners, the SEC has developed a strategy to attack the problem from all angles—from aggressive enforcement efforts, to targeted examinations, to investor education.

Fighting fraud against seniors means taking aggressive action. Over the past year, the SEC's Division of Enforcement has brought 26 enforcement actions aimed specifically at protecting elderly investors. Many of these were coordinated with state authorities.

For example, the Commission coordinated with law enforcement authorities in California to crack down on a \$145 million Ponzi scheme that lured elderly victims to investor workshops with the promise of free food—and then bilked them out of their retirement money by purporting to sell them safe, guaranteed notes.

In another case, we filed an emergency action to halt an ongoing securities fraud that targeted individuals' retirement funds. At "free" dinner and retirement planning seminars, seniors were urged to invest their savings in non-existent businesses with promises of alluringly high rates of return.

By bringing cases like these, and dozens more like them, the federal government is putting would-be fraudsters on notice that they will be caught and punished if they prey upon seniors.

SEC examiners are also working closely with state regulators across the country to stop abusive practices before seniors are actually injured. With our state part-

ners, we're sharing regulatory intelligence about abusive sales tactics targeting seniors, and conducting focused examinations of any firms whose practices raise red flags.

For example, in Florida we initiated an examination sweep of firms selling investments to seniors, in cooperation with the State of Florida and the National Association of Securities Dealers. We subsequently expanded the sweep to include other states with large retiree populations—including California, Texas, North Carolina, Alabama, South Carolina, and Arizona. Working together with state securities regulators in those states, the NASD, and the NYSE, our goal is to see to it that the sales people at "free lunch" seminars are properly supervised by their firms, and that the seminars are not used as a vehicle to sell unsuitable investment products to seniors.

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.

GLOBAL SECURITY RISK

Another important area of focus for the Commission is a program of significant interest to you and other members of this subcommittee—the agency's Office of Global Security Risk. As you know, this office, which is located within the Division of Corporation Finance, is responsible for monitoring companies' disclosures regarding their contacts with countries that have been identified by the State Department as state sponsors of terrorism and coordinating with other federal government agencies to ensure the sharing of relevant information.

The Office reviews Securities Act registration statements and Exchange Act filings whenever it appears that a company may have material contacts with countries that raise global security concerns, and pursues enhanced disclosure where appropriate. In the past year, the Office issued comments to approximately 212 companies. The Office conducts reviews both independently and in concert with the rest of the Division's disclosure review staff.

In reviewing companies' disclosures, the Office draws upon a variety of data sources. The staff considers the information in a company's filings and information available from other sources. In addition, the Office continues to coordinate with other relevant federal agencies, such as Treasury's Office of Foreign Assets Control and Commerce's Bureau of Industry and Security.

I fully support the goals of this office and believe its efforts are increasing the quality of information that investors receive regarding companies' contacts with countries identified by our government as state sponsors of terrorism. I appreciate the leadership of this subcommittee in endeavoring to ensure that investors have the relevant information they need to make informed investment decisions regarding the foreign activities of the companies that they own. And I am confident that the Office of Global Security Risk is well positioned to continue fulfilling these vitally important responsibilities.

RETURNING FUNDS TO WRONGED INVESTORS

We at the SEC work diligently to uncover fraud against investors, gather the evidence needed to build a case, and then prosecute cases to bring fraudsters to justice. But our efforts do not end at the courthouse door. Once we succeed in convincing a court to order a penalty, we must ensure that as many of those dollars as possible go back into the hands of wronged investors as quickly as possible.

Since the Sarbanes-Oxley Act created "Fair Funds," through which penalties in SEC cases can be returned directly to injured investors, the SEC has begun to develop a considerable expertise in using this important new authority. At the time I became Chairman in 2005, this authority was only three years old, and the SEC had completed the process of disbursing funds to investors in only a few cases. Since then, we have returned over \$1.7 billion to injured investors, including significant distributions from cases involving WorldCom, Global Analysts Research, New York Stock Exchange Specialists, Hartford, and Bristol-Myers Squibb. In addition, several large disbursements are pending and will be announced shortly.

To completely fulfill the vision that Congress wrote into Sarbanes-Oxley, however, will require a sustained effort within the Commission to train professionals in this

area, to develop consistent practices, and to routinize the execution of the Fair Funds function. Too much money is still undisbursed because of the complexities of the process, leaving investors uncompensated.

That is why I have ordered the creation of a new office that will focus the efforts of all of the SEC's offices around the country, and work full-time to return these funds to wronged investors. The creation of this specialized function within the SEC will ensure that investors' money is returned as quickly as possible, while minimizing the costs of the distributions.

The efforts of this new office will be aided by a new information system, called Phoenix. The system will more accurately track, collect, and distribute the billions of dollars in penalties and disgorgements that flow from our enforcement work. The efficiency of a dedicated tracking system will remove what had been a major hindrance in our efforts to quickly distribute Fair Funds.

The agency is taking other steps in this area as well. We are collaborating with the Bureau of the Public Debt to invest disgorgement and penalty funds in interest-bearing accounts. And we are working to consolidate funds from related cases into a single distribution, where appropriate, to potentially save investors hundreds of thousands of dollars.

The SEC is dedicated to doing the very best job possible for investors in handling this responsibility. We know that you in the Congress, who entrusted us with this task, expect and deserve no less.

INTERACTIVE DATA

Another major initiative I want to bring to your attention holds great potential for investors. By using what I call "interactive data," we can give investors far more information, in far more useful form, than anything they've ever gotten from the SEC before. In the very near future, investors will be able to easily search through and make sense of the mountains of financial data contained in current company disclosures.

For years, ordinary investors have been stymied by the time and effort it takes to separately look up each SEC filing for a single company they might own, and then to do that again and again for every additional company in which they're interested. Even once the right forms are located, wading through all of the legal gobble-dygook to find the right numbers has been nearly impossible for the average retail investor.

That is because the SEC's online system, known as EDGAR, is really just a vast electronic filing cabinet. It can bring up electronic copies of millions of pieces of paper on your computer screen, but it doesn't allow you to manage all of that information in ways that investors commonly need.

Not surprisingly, financial firms—who can afford it—usually end up getting the bulk of their information about companies not from the SEC filings, but from middlemen all over the world who re-key the information in SEC reports and put it in more useful form. This process is expensive and inefficient, and it also creates errors in the data. Worse, it feeds the notion that the rich and the highly sophisticated have a leg up in today's markets.

Interactive data will let any investor quickly focus on the disclosure they need. With a few clicks of the mouse, investors will be able to 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 a unique label, written in the eXtensible Business Reporting Language (XBRL) computer language.

The agency has taken a variety of steps to expand the use of interactive data. First, the Commission created a voluntary program for companies and mutual funds to submit disclosures using XBRL, and offered expedited reviews of disclosures if firms agree to share their experiences with the agency. More than 35 companies, including some of corporate America's biggest names, are already participating in this program.

Second, the SEC is working with outside groups to develop the standardized computer labels for different kinds of numbers that appear in financial statements. The collections of these labels for each industry—the so-called "taxonomies"—will be completed in 2007. With the taxonomies available to every SEC registrant, we will have in place the basic building blocks of the universal language that explains the components of every firm's financial statements.

Third, the agency is modernizing the entire EDGAR system to convert it to one based on interactive data. As part of this effort, the SEC expects to rename the EDGAR system in 2007.

In all, the Commission is investing \$54 million over several years to build the infrastructure to support widespread adoption of interactive data. Companies have told us that the costs of implementing XBRL are minimal, while the benefits are substantial. In addition to providing far more useful information to investors, we believe the use of interactive data will be more efficient for companies' internal processes, for their registration and compliance reporting to the SEC, and for the SEC's own disclosure reviews for regulatory and enforcement purposes.

CREDIT RATING AGENCIES

Finally, I want to discuss a significant new responsibility that the SEC is undertaking this year to oversee credit rating agencies. This new role was given to the SEC by Congress last year.

As you know, in 2006 the Congress gave the SEC both the responsibility and the authority to register and inspect the nation's credit rating agencies, including industry giants Standard & Poor's, Moody's, Fitch Ratings, A.M. Best, as well as several other large, medium, and smaller current and potential industry participants. Because of congressional concern that the industry faces potential conflicts of interest, imposes barriers to entry for new rating agencies, and has failed to warn the market of such significant impending financial failures as Enron and WorldCom even immediately before their collapses, the SEC is tasked with devoting significant manpower and resources to this area.

Under the new law and the SEC's proposed implementing rules, credit rating agencies will be required to register with the Commission. In addition, they will be required to submit to periodic inspections to insure that they are implementing policies to mitigate conflicts of interest, prevent leaks of material non-public information, and refrain from unfair or coercive practices. The SEC takes this new responsibility very seriously. We remain committed to finalizing the new rules by the statutory deadline, and we will assemble a team of staff to oversee the program and begin conducting inspections over the next several months.

FISCAL 2008 REQUEST

With all of this as background, I'll take just a moment to provide some useful detail about the President's budget request for fiscal year 2008.

As you know, the request is for \$905.3 million. That will permit the agency to maintain its staffing levels from 2007. This level personnel strength, which as you know is significantly higher than five years ago, will permit the agency to vigorously pursue its mission and maintain strong regulatory, enforcement, examination, and disclosure review programs.

This funding level will allow the SEC to continue its commitment to information technology, which has the potential both to reduce regulatory costs and to give investors vastly more useful information than what they receive today. In addition to the SEC's interactive data initiative, the SEC is deploying new systems to better manage enforcement and examination resources, to help us manage a higher level of enforcement activity at existing personnel and funding levels. There is absolutely no question that these technology improvements will make the SEC more productive, and give both investors and taxpayers better value for their money.

Over the last two years, the SEC has made tremendous progress in improving its operations. The fiscal 2008 request will permit us to continue improving the agency's internal financial controls. The agency has poured tremendous energy into this area during my tenure as Chairman. I am pleased to say that these efforts have generated success: under the leadership of a new Executive Director, the SEC received a clean opinion on its audited financial statements for 2006 and, for the first time, there were no material weaknesses in internal controls. This is vitally important, Mr. Chairman, because the SEC must set the example not only for other federal agencies, but for all public companies whose financial statements and disclosures we review. For this reason, the SEC will continue to upgrade its financial system, and to beef up security over its information systems.

The President's budget request also will fund pay raises for SEC staff, in accordance with the SEC's pay parity authority and our collective bargaining agreement. This is a significant fact. Including cost-of-living increases, career-ladder promotions, and merit pay increases, these raises amount to between five and six percent each year. Given that from a budgetary standpoint the increases are essentially automatic, and given further that payroll represents about two-thirds of our budget, the agency's total budget has to increase by over 3.5 percent just to maintain personnel at a steady state from year to year.

Finally, and most importantly, the level of funding in this budget request will give the SEC the tools we need to address new, emerging risks in the nation's capital

markets—including not only such known areas of concern as hedge fund insider trading, the safety and security of 401(k) plans, and the quality of disclosure to protect against fraud in the municipal securities market, but also those threats to market integrity and investor confidence that have yet to emerge.

CONCLUSION

Thank you for this opportunity to discuss the SEC appropriation for fiscal 2008. I look forward to working with you on the best ways to meet the needs of our nation's investors, and I would be happy to answer any questions you may have.

SIMPLIFYING INVESTMENT INFORMATION

Senator DURBIN. Let me ask you a few questions. Most Americans may come in contact with your agency when they receive quarterly reports on their mutual funds or stocks that they own, and I assume that the contents of those reports are monitored, regulated by the Securities and Exchange Commission. Is that correct?

Mr. COX. That is correct.

Senator DURBIN. I would dare say as an attorney with little business background beyond law school that I find these overwhelmingly boring and unintelligible. Has anyone at the Securities and Exchange Commission taken a look at the required disclosures to try to follow the model that you suggested for EDGAR, to bring this down to a level where it might have some value to the average person, to require in simple, understandable terms some fundamentals about mutual funds that we own or stocks that we own, things that we should be aware of in the most direct way?

Mr. COX. Absolutely, Mr. Chairman. You are singing our song; we are singing your song. You sound like the average American customer that the SEC is supposed to be serving. When I have a chance to address large audiences, I often ask them: When you get your proxy information or your annual report in the mail, the SEC-mandated disclosure for the mutual fund or the stock or the security that you own, do you rush to your comfortable chair and sit down, open it up and read it? Nobody raises their hand and says yes to that.

I ask: How many of you—tell the truth—throw it away? And the whole room will raise their hand. I think the SEC has to be very concerned when the customers are throwing away the product.

The whole point of this exercise is meant to serve ordinary investors. Now, we recognize that what is being described is complex, and sometimes there is some required complexity in fully disclosing what is going on. But there is also a lot of complexity that is getting in the way, that is making it hard for investors to understand this information. Increasingly, I think, as we move to web-based tools, we are going to find that we can layer this information so that there can be some clearly understandable information on top; and then, if you want to keep drilling down for hyper-technical detail, you can find it. That I think holds great promise.

But, meanwhile, we are focused on plain English in all of the retail disclosures for which the SEC is responsible. We have a ways to go there, Mr. Chairman. I recognize that. But it is a top priority for the Commission in everything that we do.

Senator DURBIN. So let me ask you, do we have to change the law so that we can receive reports that are intelligible and of practical value to investors? Is it congressional responsibility or do you

have the power at the SEC to say that these things that you are mailing to millions of investors all over America, should at least have in the first four or five pages in very plain English important information that they should know about the company that is involved in it?

Mr. COX. We definitely have the power to do this. We are doing it now very formally in rule. The executive compensation disclosure that investors are receiving for the first time this year, much more detailed information about what the boss makes than they have ever had before, must be by rule in plain English, and we are going to review these disclosures with that in mind.

Senator DURBIN. Good.

PRIVATIZING SALLIE MAE

Now let me ask you about the proposed sale of Sallie Mae. This proposal suggests that it may be purchased largely by private entities, except for two banks. Chase and Bank of America, I believe, are involved in the proposed purchase of Sallie Mae. From the viewpoint of the public and especially students and their families, the current disclosures by Sallie Mae through SEC and other Federal agencies gives us an insight into how this agency is operating.

Should we have concern that if this private sale goes forward there will be less information available about how the new entity is operating, how student loans are being handled, the compensation of officers, how it is being spent? What kind of disclosure level do you think there would be in this new entity that is proposing to buy Sallie Mae?

Mr. COX. Well, it is an excellent question. Obviously the Congress has a special interest and the public has a special interest in GSE disclosure. There has been voluntary disclosure that is meant to conform with the SEC requirements that apply to all public companies. There is nothing that would prevent that under any private ownership.

Senator DURBIN. But would it have to be voluntary? This is what I am getting to. When I have raised this question with one of the banks involved in the proposed sale they said: Well, we have so many things we are already disclosing; there will be more disclosure than you know what to do with. So I was trying to get to the bottom line. Current disclosure standards for a public corporation like Sallie Mae I would assume are at this level [indicating], and now that we have a private entity buying this public entity will the disclosures at least reach this level [indicating] of information and transparency?

Is this something that maybe I could ask your staff to take a look at and give us some feedback?

Mr. COX. We are, as you can imagine, keenly interested ourselves, and I would be happy to continue to work with you on this.

Senator DURBIN. Good.

SUDAN DIVESTMENT

Before I turn it over to my colleague here for a few questions, let me ask you about the situation in Sudan. I contacted you earlier this year about the divestment interest which I have in order to put pressure on the Sudanese government to finally respond to the

genocide in Darfur, which has been acknowledged by this administration. After receiving some information from your Commission—there was a list of some 16 companies—it turns out that that is only a fraction of the actual activity that goes on in Sudan.

When we asked your staff why we did not have more information, we were told that the SEC can only compile such a list based on available information and such a list is obsolete almost as soon as it is created since companies shift operations continuously. So we are now working with Treasury and the State Department to create stronger reporting requirements to the SEC so that better information is available.

Before I ask you the specific question, I would like to add a footnote to that. There has been a great deal said recently by myself and others about Fidelity, a major brokerage company which it has been alleged has large holdings in PetroChina, the largest oil company in Sudan. You may have seen some ads on television and in publications. We were informed today it has been announced that Fidelity has sold at least 30 percent of the \$1.1 billion in Hong Kong-listed PetroChina shares held as of December last year. We are still looking into it to determine how much they have divested.

But going back to my earlier point, if we are looking for companies like Fidelity and others doing business in Sudan, what do you recommend that we do to ensure the SEC can collect the kind of data that makes our effort more likely to succeed?

Mr. COX. As you know, Mr. Chairman, your efforts, which we have been assisting, I think are properly aimed at a universe that is larger than just U.S.-listed companies, and the PetroChina example that you gave—PetroChina did not appear on the list that we provided of our registrants for the simple reason that it was not a U.S.-listed company. That is, the subsidiary listed in the United States did not have material contacts in Sudan and the parent, PetroChina, is not a U.S.-listed company. Because of the U.S. sanctions regime, not very many listed U.S. companies are the entities that themselves have the material contacts.

So I think, if we are after the information that you seek, we need to broaden our horizons a little bit. Although the SEC can be very helpful in this regard, and I know that you are also working with the Treasury Department and the State Department, I think a multiagency effort is the best way to go.

Senator DURBIN. Well, I hope we can find that information, because I think at a minimum if Americans who are concerned about the issue are alerted to those companies that are doing business in Sudan and have a choice as consumers and investors to act accordingly that is the best we can do at this moment in time. We need to have a more robust effort to bring this information together and I will work with you to achieve that.

I see Senator Brownback has arrived. I do not know if you would like to ask or let Senator Allard.

Senator BROWNBACK. Let Senator Allard.

Senator DURBIN. Senator Allard is recognized for 5 minutes.

NASD-NYSE CONSOLIDATION

Senator ALLARD. Thank you, Mr. Chairman. I mentioned in my opening comments about the consolidation of the National Associa-

tion of Security Dealers and the New York Stock Exchange regulatory function. The question I have for you, Chairman Cox, it is my understanding that the Division of Market Regulation is going to be responsible for regulation and supervision of the proposed consolidation. Do you feel that the SEC's budget request provides enough for these challenges and other initiatives that will modernize the national market system?

Mr. COX. I do. In fact, I think in some ways the consolidation of the regulatory functions of the NASD and the NYSE will make it easier to track fraud across markets. We had a problem heretofore with the sheriff having to stop at the county line. Fraud does not neatly restrict itself these days to one particular platform, one particular market, and, to the extent we have a more crosscutting view of what is going on in our market surveillance, we will be much more efficient at tracking down fraud.

PROGRAM ASSESSMENT RATINGS

Senator ALLARD. As you will recall when we were in the House, the Contract with America, we worked with the Government Performance and Results Act (GPRA) and the way that became law and the way the Government agencies now is implementing it is the President's PART program. I am developing a reputation that on these Appropriations subcommittees I always ask whoever is testifying about how well their agency is doing in the PART program.

I look here and I pulled the information off of the Internet on Expectmore.gov, and I see where the Securities and Exchange Commission, you have four programs that they refer to. The regulation of the investment management industry is listed as effective, and I congratulate you on that. The examining and compliance with security laws, that is characterized as moderately effective. Then there is a couple of agencies, what we call the Securities and Exchange Commission enforcement and then the Securities and Exchange Commission full disclosure program, that it says results not demonstrated, which tells me that they are not bothering to set objectives and try and move toward those.

Now, I noticed in your comments that you referred to these programs and that some of the money you are requesting is to upgrade those programs. So my question is how are you coming along on getting more accountability in those two particular programs, where results are not demonstrated?

Mr. COX. First, thank you for asking about this, because it is something that we are very focused on from a management standpoint at the SEC. You are right to point out that the 2007 PART review that focused on the Division of Investment Management gave the SEC the highest rating. As you know, that rating of "effective" is very rarely awarded. It is hard to get, and so that was cause for I think well-deserved celebration at the agency. We are very proud of having achieved that in 2007.

Likewise, the Office of Compliance, Inspections, and Examinations received the next to the highest rating last year. Prior to the time that I came to the Securities and Exchange Commission, these other reviews that you mentioned were performed. The Enforcement Division, results not demonstrated, and the Division of Cor-

poration Finance likewise, are for that reason very much in our focus. We are working right now with the Government Accountability Office (GAO), which is performing another management review of the Division of Enforcement, and we hope that, as a result of that collaboration and also our own internal management assessment, we will be able to develop additional measurable performance ratings.

The enforcement area, as you can imagine, it is difficult. We are first and foremost a law enforcement agency, and it is the greater part of what we do. So we are very interested in anything that we can do to measure results.

One of the things that we observe in the economy right now is that there are fewer security class actions being filed now than there have been in prior periods. There are a number of potential explanations for that, and I think only social scientists can parse, perhaps only to their own satisfaction, what the causes are for this.

But looking for a measure of less fraud, which would be the ultimate performance that you would like our enforcement to achieve, is very difficult. So we are trying to come up with any way that we can measure this. We probably will not use such external measures for the reason that there is so much social science involved. But certainly we are going to develop even more rigorous measurements than we have used in the past so that we can satisfy ourselves that the taxpayers' resources are being put to the best use for the protection of investors.

Senator ALLARD. Well, thank you for your response. Next year when you show up I will probably repeat that question and see how well we are doing.

Now, has the GAO reviewed from the PART program perspective, have they reviewed all your programs, and if not how many more remain to be reviewed?

Mr. COX. Well, the GAO has on a number of occasions reviewed aspects of the SEC's operations. Their current ongoing study involves the Division of Enforcement.

Senator ALLARD. Okay. So are there more programs that need to be reviewed yet that are not listed on here, or is this pretty much it?

Mr. COX. Well, the PART program, as you know, picks a different portion of the agency each year.

Senator ALLARD. Right.

Mr. COX. And I do not know, frankly, where the Office of Management and Budget (OMB) will go next.

Senator ALLARD. Okay. Well, we will want to follow up on that one too.

Thank you for your testimony.

Mr. COX. Thank you.

Senator DURBIN. Senator Brownback.

Senator BROWNBACK. Thank you, Mr. Chairman.

Welcome, Chairman Cox. Good to see you again. I want to join the chairman in his comments on Sudanese divestiture. We have a strong, growing campaign across the country. I am not sure where we are on the number of States. I do know Kansas just divested. We have probably between 8 to 10 States now that are involved in public divestiture from Sudan. I would hope you could

help us out with that. It seems to me that is one of the best ways that a citizenry can express its displeasure with the genocide. You can say, you can conduct a genocide, we do not like it, and we are going to fight you every bit of the way, but it is certainly not going to be on our dime that you are going to do it. So your willingness to help is greatly appreciated.

DECLINE IN IPOS ON U.S. EXCHANGES

I want to target you in on two things that have been seen in some of the publications. One is the reduction in IPOs in our capital markets that have been the subject of a number of articles recently, the New York Times, Wall Street Journal, Financial Times, and Economist. There is a recent report from McKinsey and Company commissioned by Senator Schumer and New York City Mayor Bloomberg that found in the first 10 months of 2006 U.S. exchanges attracted barely one-third of the share of the IPOs they captured back in 2001. They noted at the same time European exchanges increased their market share by 30 percent, and Asian exchanges doubled their share.

The study found the trend was due to non-U.S. issuers' concern about compliance with Sarbanes-Oxley (SOx) section 404 and operating in what they see as a complex and unpredictable legal and regulatory environment.

I would ask you, as I am sure you have seen the same things, do you agree with these findings and what could be done to stem this flow of companies going to foreign exchanges?

Mr. COX. Well, Senator, I think the United States always needs to be focused on sharpening our competitive edge in every way that we can. The SEC has, of course, as our statutory mission protecting investors, but another statutory mission of the Securities and Exchange Commission is promoting capital formation, and we are focused on that, as we are focused on our third statutory mission, which is maintaining orderly markets. All of these things I think are complementary.

We have to be concerned, when we see that there is more competition in the world now than there ever has been before, to see that the United States of America has a regulatory system that is pro-competition, that is efficient, that achieves all the objectives of investor protection that we want, but that it also succeeds in our market regulatory objective and also our objective of—

Senator BROWNBACK. Do you think it is due to section 404 of Sarbanes-Oxley? Is that a key part of why we are losing competitiveness?

Mr. COX. We have heard from foreign private issuers who listed in the United States that they are very concerned about the operation of section 404. We have also heard that same complaint from U.S. issuers. Because of this, we have gone back to the drawing board. We are on the threshold—and it will occur on May 23 and May 24—of repealing in its entirety the audit standard that was issued shortly after the passage of Sarbanes-Oxley by the Public Company Accounting Oversight Board under SOx 404 and replacing it with one that has the benefit of the interim years of experience.

It is going to be top-down, risk-based, principles-based, materiality-focused, and scalable for companies of all sizes. None of those things was really a forte of the original standard.

Senator BROWNBACK. Do you think that will get at this loss of the flight of companies to foreign markets?

Mr. COX. That is certainly a part of it. But I started with a reference to competition for this reason. There is more competition now than there used to be. In days gone by there simply were not the large pools of capital around the world to tap, nor the technological means and the commercial means that would offer a feasible choice for many issuers.

Today that competition exists. I think the competition itself is good. It is healthy. It tends to reduce the cost of capital. But we want to make sure that that competition is not a regulatory competition that lowers standards for investor protection. So we are working with our counterpart regulators to make sure that, as we flense the blubber from the regulatory system and wash out any unnecessary costs, we, if anything, increase the level of investor protection by closer collaboration overseas.

If you take a look at what is actually going on in the markets, while it is true that the lion's share of foreign IPOs went elsewhere and we did not attract them in the United States in recent years, this year we are on track, according to Thomson Financial, to add the most foreign listings on U.S. exchanges since 1997. That is a good development.

It was also recently reported that foreign companies accounted for over 23 percent of IPO proceeds last year, and that is the highest since 1994. So there is every reason to think that the United States will maintain its lead and the largest market share on Earth. We are still the largest, deepest, most liquid pool of capital in the world. But we do not want to take that for granted, and regulators as well as marketplace participants all have to constantly sharpen our competitive edge.

Senator BROWNBACK. I appreciate you looking at that and considering that. I am putting in a bill today on the Communities First Act, that is to provide targeted regulatory relief for community banks—these are small banks across the United States—that will provide some relief on section 102 of Sarbanes-Oxley by exempting insured depository institutions with consolidated assets of \$1 billion or less from provisions of the internal control requirements in section 404.

I just advise you of that. In my State we have a number of small banks, small institutions. A number of the Sarbanes-Oxley provisions have been very difficult, very onerous on them, and this regulatory relief would be something that would be helpful. I want to make sure that this regulation is not putting the United States at a competitive disadvantage in global capital markets.

I appreciate your answer and working with us on these topics. Thank you, Mr. Chairman.

Senator DURBIN. Thank you, Senator Brownback.

RIGHTS AND REMEDIES AVAILABLE TO INVESTORS

A few more questions if I might. It is my understanding, Chairman Cox, based on the Wall Street Journal article of April 16 that

the SEC is exploring the idea of eliminating the rights of investors to pursue legal remedies in court, instead shifting to arbitration. Inasmuch as your responsibility as Chairman of the SEC includes protecting investors and maintaining fair, orderly, and efficient markets, I would like to ask you a few questions if I might.

You stated earlier there are fewer class actions that are being filed, which is an indication that the litigation rate is not increasing. But when it comes to this suggestion of moving the rights of investors to arbitration as opposed to the court system and this limitation of the legal rights of investors, how would you rationalize that decision against the fact that most of the arbitration hearings are going to be private in nature and some of the most dramatic information we have received about corporate wrongdoing, such as the *Enron* case, came in public forums, before the courts, leading to congressional response and perhaps a little more wariness on the part of investors?

Are you not going to sacrifice some of that openness and transparency in this process if you move to an arbitration standard?

Mr. COX. Well, Mr. Chairman, I appreciate the opportunity to state very clearly, as I did to the reporter who wrote the story that you mentioned, that there is no pending rule or proposal before the Securities and Exchange Commission to allow corporations to mandate arbitration of shareholder claims. The source for the story is unclear. It was not explained to me by the reporter. But, as you will note, there were no other such stories, and I hope that I can speak authoritatively to that subject.

Senator DURBIN. Thank you.

EXPEDITING FAIR FUND DISBURSEMENTS

Let me ask you, you have addressed this earlier, but I want to make sure it is clear in the record here. The fair funds for investors provision in Sarbanes-Oxley requires the SEC to return money to investors victimized by securities fraud. I think that your earlier statement was that you were making a more concentrated effort in trying to return these funds. The Government Accountability Office determined that as of 2005 the SEC had disbursed money to wronged investors in only a few cases—that is in 2005—and criticized the SEC for its slow process for disbursing more than \$4.8 billion in disgorgement and penalties it had collected during the previous 3 years. While the SEC had used the fair funds provision in 75 cases, collecting money in a majority of those cases, the investors in only 3 of those cases had received any money.

You quoted an earlier figure which I believe was \$1.8 billion. I may be wrong.

Mr. COX. \$1.7 billion.

Senator DURBIN. \$1.7 billion.

Could you tell me, what is the status of this fair funds activity and whether that represents—it does not represent one-half, I believe, of what the GAO reported. But does it represent or is it an indication that this next year there will be even more funds to be disbursed?

Mr. COX. It is in fact, Mr. Chairman. The figures that you mentioned and the report that you mentioned from 2005, of course, represented the state of affairs that I found at the agency when I be-

came Chairman in August 2005. That is why I made it an immediate priority. The \$1.7 billion that we have distributed as of now is a substantial increase over what was the case in 2005.

There is also \$3.4 billion that we are very soon going to be able to distribute that relates to the recent mutual funds scandals, and that will be then the lion's share of the \$3.8 billion remaining backlog.

Senator DURBIN. Let me ask you about the WorldCom matter. The SEC collected \$750 million in penalties and fines there. Could you tell me, what is the status of that reimbursement? I understand some \$150 million should be doled out to investors.

Mr. COX. We have recently distributed \$500 million, beginning this past October. There is, however, more to be distributed. The \$750 million in total fair fund that was established and approved by the court in July 2004 was subsequently appealed to the Second Circuit Court of Appeals, and they then approved the lower court's decision in October 2006.

WorldCom also recently emerged from bankruptcy and there was a 9-month claims period because WorldCom was one of the most heavily traded stocks in the market and was widely held by small investors. The former Chairman of the Securities and Exchange Commission, Richard Breeden, is serving as our distribution consultant in this matter, and he has submitted a distribution plan that we started executing immediately after they emerged from bankruptcy.

VOLUME OF DISCLOSURE REVIEWS

Senator DURBIN. Mr. Chairman, your budget submission projects that the Divisions of Corporate Finance and Investment Management expect to review the disclosures of about 33 percent of all reporting companies and investment company portfolios. In last year's request you indicated that 44 percent of the disclosures would be reviewed. First, how do you select the disclosures to be reviewed? What is the total volume of filings, and why would you propose in next year's budget a 25-percent decrease in the number of disclosure reviews?

Mr. COX. The basis for the selection of submissions to review is risk. That is true not only in the Division of Corporation Finance, but it is true in our Office of Compliance, Inspections, Examinations, and the Division of Enforcement.

SOx requires now that we review all the registrants once every 3 years, and so we are embarking upon that approach separately. The volume of filings as against the risk of filings gives us a trade-off, therefore, that we have to make, because SOx is just purely quantitative. We have got to get to all of them ultimately. On a risk-based approach, we can focus our resources where they are better used.

The figures that we provided to you about the number that we expect to reach are projections; and we do not know precisely where we will end up, of course, until we have the experience.

Senator DURBIN. Why would the percentage of those reviewed decline by 25 percent from this fiscal year to next fiscal year?

Mr. COX. That is simply an estimate based on meeting our SOx obligations at the same time that we pursue a risk-based approach to reviewing the filings.

SCHEME LIABILITY LITIGATION

Senator DURBIN. Let me ask you about the issue of scheme liability litigation. The SEC has in the past taken the position in amicus curiae filings that someone who engages in deceptive conduct may be liable for engaging in a scheme to defraud even without making false statements directly to the public if the person undertook acts with the purpose and effect of creating a misleading impression. For example, in October 21, 2004, the SEC filed a brief in the *Home Store* case in the Ninth Circuit saying that if a third party engages with an issuer of securities, "in a transaction whose principal purpose and effect is to create a false appearance of revenues intending to deceive investors in the corporation's stocks, it may be a primary violator."

The Ninth Circuit relied on the SEC's interpretation in its ruling and said: "We agree with the SEC that engaging in a transaction the principal purpose and effect of which is to create the false appearance of fact constitutes a deceptive act."

Has anything occurred, Mr. Chairman, in the past 3 years that would cause the SEC to change its position on the liability of third parties?

Mr. COX. No.

Senator DURBIN. The issue of scheme liability is going to be before the Supreme Court next term in the *Stoneridge* case. This is also an issue that is at the heart of the decision by the Fifth Circuit effectively denying the Enron victims their day in court against the investment banks allegedly involved in the fraud. The SEC has an opportunity to file an amicus brief on June 11 standing up for its own rule and for the integrity of the financial markets, as it did in the *Home Store* case. Can investors count on the commission's support?

Mr. COX. As you know, Mr. Chairman, the Solicitor General will file a brief on behalf of the United States. The SEC will, I believe, soon receive a recommendation from our General Counsel on precisely how to proceed in that particular case. The Commission will vote on it, and then we will make our recommendations to the Solicitor General.

I expect that the net result of all of that will be that the United States Government will do its level best to make sure that injured Enron investors receive the full amount of recovery to which they are entitled in our legal system.

Senator DURBIN. So this matter has not been decided? It will be under consideration after the Solicitor General—

Mr. COX. Yes, this is all relatively recent in the last few weeks.

STUDENT LOAN REPAYMENT FOR SECURITIES AND EXCHANGE
COMMISSION EMPLOYEES

Senator DURBIN. I would like to ask you one last question. Do you use student loan forgiveness to recruit and retain professional personnel?

Mr. COX. It is an excellent question. I do not know the answer. Let me see. Yes. Our Executive Director, sitting right behind me, tells me that we do.

Senator DURBIN. The staff just handed me a long list of people who have benefited from this. So it appears that you do use it. In fact, I would like to congratulate you for being a Federal Government leader in using this program. It turns out 365 employees receive some money in student loan repayment benefits. This is a program which I have encouraged. I think it is an excellent way of attracting the best and the brightest to public service when they are burdened with student debt and might consider other careers. So I hope that you will continue to use that.

Mr. COX. We certainly will take your enthusiasm as it is intended.

Senator DURBIN. Thank you very much, Mr. Chairman, for testifying today. I thank all those who have come from the Securities and Exchange Commission.

ADDITIONAL COMMITTEE QUESTIONS

Our record will remain open for 10 days if there are any written questions to be sent to you from our staff or the staffs of the other Senators involved.

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

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

ARBITRATION

Question. In response to an inquiry at the hearing, you mentioned that a report in The Wall Street Journal that the Commission is considering a proposal originally described in the Capital Markets Study that would empower corporations to amend their bylaws to mandate arbitration of securities fraud class action cases was “inaccurate” although you did not specify how the article was inaccurate. What assurance can you provide the Subcommittee that the SEC is not considering any changes regarding arbitration?

Answer. There is no pending rule or proposal before the Commission to allow corporations to mandate arbitration of shareholder claims. Corporations should not be able unilaterally to limit the rights of investors to sue, and I can assure you that the Commission does not plan to advance any proposal that diminishes investor rights.

MARKET COMPETITIVENESS

Question. Three recently issued reports—the Committee on Capital Markets Regulation Report, the McKinsey Report, and a report from the U.S. Chamber of Commerce—raise concerns about the competitiveness of the U.S. capital markets. These reports concluded that the competitiveness of the U.S. markets is being hampered by our overzealous regulatory and litigation environment.

All three reports relied on the same fact to support their claim—that the U.S. share of the global IPO market dropped between 2000 and 2006. This statistic, however, is highly misleading. In fact, since the implementation of the Sarbanes-Oxley Act, the number of U.S. IPOs has risen dramatically. According to a recent article in Barron’s, IPOs in 2006 increased 22 percent over 2005, and 170 percent over 2003. During that same period, the number of foreign companies listing in U.S. markets and the amount of money they raised here have also increased.

Furthermore, a recent study by Craig Doidge of the University of Toronto and Andrew Karolyi and Rene Stulz of Ohio State University found that there remains a significant premium for companies that list in the United States, and this premium has not declined in recent years, despite recent regulatory developments. The pro-

fessors also found that an exchange listing in New York still continues to provide significant benefits to firms.

These facts confirm that U.S. markets are among the most highly competitive in the world, and suggest that we are so competitive precisely because of the unmatched protections we provide to our investors.

What is your opinion? Do you believe that a market that provides such protection and transparency actually increases competitiveness?

Answer. Yes. I agree. U.S. markets thrive because of the global trust we've earned. That makes the SEC itself a key part of America's capital markets that helps secure our global leadership, maintain our markets' competitive edge, and secure the benefits of robust capital formation for millions of Americans as well as countless people the world over. But the SEC can only continue in this role if we constantly update our rules, our policies, and our own way of operating to keep pace with the increasingly rapid changes in the world of finance that we regulate. The new global competition is good in that it tends to reduce the cost of capital. But we are working to make sure that that competition is not a regulatory competition that lowers standards for investor protection and ultimately undercuts America's role as the leading capital market in the world.

INVESTOR FRAUD TARGETING SENIORS

Question. Chairman Cox, in your prepared statement you discuss the SEC's initiatives to combat investor fraud schemes which particularly target seniors. I understand that the SEC recently teamed with the University of Illinois College of Law and the Federal Reserve Bank of Chicago to host a symposium focusing on this issue in Chicago.

Are there certain schemes that are aimed at older Americans?

What recommendations do you have for older Americans to better guard their retirement funds? What is the SEC doing to inform and educate consumers?

What specific actions has the SEC taken to reduce the prevalence of these unscrupulous practices? What remedies have been the most effective?

Answer. It was a great pleasure to be in Chicago on May 18 for the Senior Symposium the Commission hosted with the Elder Law Journal of the University of Illinois College of Law and the Federal Reserve Bank of Chicago. The Symposium featured a distinguished panel of representatives from the business, law, regulatory and academic communities with significant experience tackling the issues facing seniors as they prepare for and enjoy their retirement. The panelists discussed how older Americans can protect themselves from investment fraud while financially preparing for the future. It was a very instructive and successful event.

As you know, fighting fraud against seniors requires aggressive action. That's why last year I launched the SEC's "Seniors Initiative," which is designed to better coordinate the work of the SEC's various offices and divisions and with state securities regulators when it comes to prosecuting and preventing securities fraud aimed at swindling senior citizens.

Educational efforts are an important of the Commission's strategy for seniors and we are dedicated to putting better information in their hands so they can make informed investment decisions. We are conducting a series of seniors events around the country and will hold the second Senior's Summit this fall.

We know that many seniors, and many children and caregivers of seniors, use the Internet to search for information on investing. That is why we created a section on our website (<http://www.sec.gov/investor/seniors.shtml>) aimed specifically at senior investors.

The information on this website can help seniors fend off high pressure sales pitches for legitimate, but arguably unsuitable products. After reading our materials on equity-indexed annuities, for example, seniors will know to avoid any salesperson claiming that individuals "can't lose money" in that product. Investors can lose money buying an equity-indexed annuity, especially if the investor needs to cancel the annuity early.

In addition to providing critical information on other investments commonly marketed to seniors, such as variable annuities, promissory notes, and certificates of deposit, the website also provides key information about how to detect and avoid fraudulent schemes.

This is also a top enforcement priority for the SEC. Since many of the scams targeted at seniors involve ongoing fraud or Ponzi schemes, time is often of the essence—both to stop the ongoing fraud and to recover lost investor funds. In these instances, the staff may move very quickly and seek emergency relief in the district courts. Once emergency relief is obtained and the status quo is preserved to the extent possible, the Enforcement staff generally goes through the same detailed proc-

ess it would in any investigation, which include interviewing witnesses, requesting and reviewing documents, and taking formal testimony.

The existing statutory penalties provide a broad range of available sanctions, including cease-and-desist orders, censures, injunctive relief, disgorgement, civil penalties, and industry bars. Moreover, civil monetary penalties may be imposed in cases involving repeat violations and severe frauds. I believe that the Commission's full range of existing remedies allows enough flexibility to ensure that the Commission can effectively prosecute cases involving fraud against seniors. This is particularly true given the SEC's ability to make criminal referrals in the most egregious cases.

STOCK OPTION BACKDATING AND SPRINGLOADING

Question. Numerous media accounts in recent months have reported that many companies may have bent our securities laws by engaging in stock option backdating and springloading as a way to provide senior corporate management with manufactured gains.

Do you view the proliferation of this practice as a serious threat to the integrity of the securities laws which you oversee?

If so, how many cases has the SEC brought in this area in the last year?

Does the SEC need greater enforcement resources to combat compensation practices such as these?

Answer. The SEC's Division of Enforcement is currently investigating more than 140 companies for possible fraudulent reporting of stock option grants. The companies under investigation are located across the country, are of various sizes, and span multiple industry sectors. All of the SEC's regional offices are currently involved in these investigations.

Longstanding SEC policy precludes the disclosure of any information about these ongoing investigations; however, enforcement actions have been filed against former executives of Symbol Technologies, Peregrine, Brocade, Converse Technology, McAfee, Monster Worldwide, TakeTwo Interactive Software, Engineered Support Systems, Apple Inc. and Mercury Interactive. To date, the Commission has brought enforcement cases against 4 issuers and 19 former executives. These cases involved alleged misconduct of chief executive officers, general counsels, chief financial officers, and other accounting and human resources employees. The Department of Justice has also brought parallel criminal actions against 10 of the 18 former executives charged by the Commission.

The SEC has taken many steps to ensure clear, full, and fair disclosure about executive compensation, including that relating to employee stock options. The revised executive compensation disclosure rules the Commission adopted in July 2006 include a number of provisions that directly or indirectly address backdating of options. For example:

- A company must now disclose how it determines when it will make equity awards. This will require a company to disclose how, and why, it backdates for its executives.
- A company must disclose the grant date of equity awards. If the grant date is different than the date on which the board took action, the company must disclose the date of the board's action.
- A company must disclose the exercise or base price of an option if it is less than the market price of the underlying security on the grant date. If it is less than the market price on the grant date, the company must disclose the market price on the grant date. This disclosure is intended to provide an investor with a complete picture of the true terms of each option award by allowing the investor to compare the grant date market price to the in-the-money exercise price.
- Further, if the exercise or base price of an option grant is not the closing market price per share on the grant date, a company must describe its methodology for determining the exercise or base price.

In addition, the Sarbanes-Oxley Act of 2002 tightened up a company's obligation to report stock option grants. Before Sarbanes-Oxley, officers and directors were not required to disclose their receipt of stock option grants until after the end of the fiscal year in which the transaction took place—which meant that an individual, in some cases, had more than a year to disclose a grant. In August 2002, the SEC issued rules requiring officers and directors to disclose option grants within two business days.

In combination, these steps are an important contribution to preventing backdating abuse. They have effectively eliminated easy opportunities for companies to secretly grant options. Companies are beginning to file reports with disclosure of executive stock option grants in accordance with the Commission's new rules. Staff

from the Commission's Division of Corporation Finance will selectively review these reports for compliance with the new rules, including those relating to stock option awards. Where the disclosures indicate possible violations of the federal securities laws, appropriate referral of the matter will be made to our Division of Enforcement.

COMMISSION APPROVAL FOR SETTLEMENT TALKS

Question. On April 13, 2007, the Washington Post reported that SEC had made a change in procedures such that your enforcement lawyers must seek approval from the Commission before they begin settlement talks that involve fining corporations, including seeking ranges for possible fines. It has also been reported that this action may lead to lower penalties.

Please comment on whether this report is accurate and whether you believe it will lead to lower penalties and if so, was that its intent?

Answer. The Commission's procedures for authorizing settlement negotiations in cooperate penalties cases are not designed to increase or decrease the amount of monetary penalties paid by companies or to make penalty payments more or less frequent. Rather, they are intended to strengthen the negotiating position of our Enforcement Division in settlement negotiations involving corporate penalties and streamline the approval process for those cases. The implementation of the procedures will be carefully monitored, and the procedures will not be continued if they do not achieve these key objectives.

The process is designed to ensure that the laws are vigorously enforced by giving the professional enforcement staff the full backing of the Commission in the staff's settlement negotiations.

The pilot streamlines the settlement process by shortening final Commission review and approval when the staff reaches a settlement within the range authorized by the Commission.

The staff may always return to the Commission to recommend a higher or lower penalty range if their recommendation changes based on new information or a development that occurs during the settlement negotiations.

WEAKNESSES IN INFORMATION SECURITY CONTROLS

Question. In carrying out its mission to ensure that securities markets are fair, orderly, and efficiently maintained, the SEC relies extensively on computerized systems. Integrating effective information security controls into a layered control strategy is essential to ensure that SEC's financial and sensitive information is protected from inadvertent or deliberate misuse, disclosure, or destruction. In fact, one of SEC's four strategic goals is "maximizing the use of SEC resources," which expressly includes "enhancing internal controls."

A recent GAO study acknowledged that the SEC has made progress toward correcting previous weaknesses in information systems security, and attributed progress to active engagement by SEC senior management in implementing reforms. However, GAO emphasized that despite progress, the SEC has not consistently implemented key controls to effectively safeguard the confidentiality, integrity, and availability of its financial and sensitive information and systems.

GAO recommends that the SEC Chairman improve the implementation of its policies and procedures, control tests and evaluations, and remedial action plans as part of its agency-wide information security program.

Chairman Cox, what is the SEC actively doing to implement GAO's recommendations to correct information security control weaknesses?

Answer. The SEC now devotes about 7 percent of the agency's information technology budget on technology security—a significantly greater share of overall information technology resources than many other agencies. Our efforts run the gamut from highly technical initiatives such as server configuration management, to equally critical but "softer" programs such as user awareness training.

In one major improvement initiative, the SEC has invested over \$2 million during fiscal year 2006 to enhance our core financial management system. These upgrades include new hardware and software, as well as implementing a more secure database. As part of this upgrade, the SEC will continue to make enhancements to business processes and automated workflows that will improve internal controls, eliminate traditional financial management paper processes, and enhance reporting capability and efficiency. Beyond these benefits, the updated hardware and software will provide much greater assurance that the system complies with modern information security standards.

We have also taken significant steps to upgrade physical security throughout SEC buildings. Specialists have evaluated the structures and installed computerized

identification card authentication systems, cameras, and alarms in key facilities. The number of entrances at our data operations center has been reduced. Guards have been redeployed and retrained. We have also put in place new technology and changes in procedures to restrict access to sensitive rooms on SEC premises, such as data centers and network closets.

We are continuing our efforts to tighten access controls that prevent, limit, or identify inappropriate access to data, equipment, and facilities. All of these controls are designed to prevent unauthorized disclosure, modification, or destruction of sensitive information.

While the SEC has strong access control policies, a number of issues identified during the audit were related to inadequate compliance with existing agency policies by individuals responsible for the system and technical staff. To address this concern, the SEC has stepped up educational and enforcement efforts. System owners—individuals responsible for the system—have been presented with all agency information technology policies and have been directed to sign documentation showing that they have reviewed those policies. Beyond developing an educated population, we are also focused on errors that can happen through inattention. To address such issues, the SEC is implementing a systemic scanning program administered by teams that are organizationally separate from the system owners. System owners will be presented with the results of those scans and directed to correct any vulnerabilities and mitigate risks on systems that do not comply with SEC policies. By implementing a continuous scanning approach, the agency expects to achieve dramatic cost savings. These savings can be achieved because configurations will be corrected early on, before they can have a negative effect on operations. Such practices will also reduce the amount of resources and time required to correct problems in the future.

The SEC also is making efforts to address weaknesses in its IT “change management” processes. These are the processes and procedures that govern the way that software and other technologies are deployed into the SEC’s environment. The GAO has recommended a number of improvements to ensure that such deployments do not introduce security weaknesses, whether inadvertently or as the result of an insider with malicious intent. Therefore, we are taking steps to better oversee our environment through such measures as weekly change control board meetings, better communication between the involved groups, improved version management procedures, and an enhanced test environment.

As Chairman, I am committed to implementing all of the GAO’s recommendations. I anticipate that we will again see significant improvements in our information security posture at the conclusion of this year’s audit.

RISK-BASED EXAMINATIONS—TARGETED ACTIVITIES

Question. In your budget justification document for fiscal year 2008, in the section covering the Office of Compliance Inspections and Examinations and your risk-based examination program, you explain that SEC’s resources will be focused on those firms and practices that have the greatest potential for violative conduct that can harm investors.

You state that “higher-risk activities” include those that “create significant conflicts of interest where compliance policies and procedures are insufficient to mitigate those conflicts.”

Please explain in greater detail what these “higher risk activities” include, and how you target them.

Answer. Higher risk activities at adviser, funds, and broker-dealers include business practices that create significant conflicts of interest that, if not monitored and mitigated in some fashion, may result in harm to clients or investors, such as: soft dollar arrangements; directed brokerage; performance advertising; custody and possession of client funds and securities; difficult-to-value securities; access to non-public information; and significant personal trading by employees of the firm. In examinations of broker-dealers, our risk-based focus is on areas such as: compliance with capital requirements and operational issues; sales practices including suitability, churning, and unauthorized trading; supervision; new products; order handling and trading rules; and anti-money laundering rules.

The Office of Compliance Inspections and Examinations (OCIE) has implemented a risk-based approach to examinations. OCIE’s goal is to identify emerging areas of compliance risk, conduct examinations and take steps to remedy identified problems. Given the number of firms registered with the SEC and the breadth of their operations, the staff continues to focus examination resources on those registrants and activities where the investing public or market integrity is most at risk.

In recent years, the examination program has enhanced its efforts to proactively detect and address potential risks, and provide balanced, cost-effective and reasonable oversight of the regulated community. Many of these higher risk activities have been identified through years of experience with examinations and enforcement activities at registered firms. However, we are continually searching for areas of risk that are new or unique to the investment management community. To assist the staff in identifying risks warranting examination follow-up, OCIE utilizes a risk-identification and risk-assessment methodology. This methodology uses an internal database to identify and prioritize risks, consider mitigating and aggravating conditions, and recommend regulatory or other actions to be taken to remove or mitigate the risks. As part of this risk assessment process, examination staff nationwide provide feedback about where risks may exist in the industry and to propose possible solutions. This risk-assessment process is used to identify risks requiring regulatory or examination follow-up and to build a culture of risk-assessment within the examination program.

Higher risk activities are targeted primarily through our examination process. All of our routine examinations will focus on those activities and areas presenting the greatest concern to investors (many of which are identified above). In addition, exam staff may specifically conduct focused risk targeted examination sweeps to determine the extent and interpret emerging risks in the regulated community. In such examinations, examiners review risk conditions and responsive controls for a particular compliance risk at a sample of firms. This approach allows the staff to obtain a more comprehensive view of the particular risk, assess the gravity of the risk, evaluate the compliance performance of individual firms compared to that of their peers, and suggest regulatory solutions. These examinations may often identify specific areas of interest and risk that are incorporated into our regular examination process.

QUESTIONS SUBMITTED BY SENATOR SAM BROWNBACK

Question. As I mentioned in my statement, recent articles in the “New York Times,” “Wall Street Journal,” “Financial Times” and “The Economist” have all suggested that tenets of Sarbanes-Oxley are cause for a decrease in American-listed public companies compared to foreign exchanges such as London and Hong Kong, because the Act takes away incentives to list on an American exchange. Do you agree with this assessment?

A recent report by McKinsey & Company commissioned by Senator Schumer and New York City Mayor Bloomberg found that over the first ten months of 2006 U.S. exchanges attracted barely one-third of the share of IPOs they captured back in 2001. During that same time, European exchanges increased market share by 30 percent and Asian exchanges doubled their share. Most importantly, the study found this trend was “due to non-U.S. issuers’ concerns about compliance with Sarbanes-Oxley Section 404 and operating in what they see as a complex and unpredictable legal and regulatory environment.” Do you agree with these findings? What can we do to stem the flow of companies to foreign exchanges?

Answer. 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. These reports, including the report by McKinsey & Company commissioned by Senator Schumer and Mayor Bloomberg frequently cite the increase in foreign-listed IPOs as cause for concern about the competitiveness of U.S. markets, and cite the Sarbanes-Oxley Act as a contributor to capital flight from the United States.

I agree that Sarbanes-Oxley is a factor in the decision of some issuers to list overseas. I am comfortable stating this because several issuers, underwriters, accountants, and attorneys have shared the reasons behind their decisions to list overseas with me and have cited SOX as a reason. But despite this kind of unfiltered, episodic information much more is at work here. We need to recognize that our capital markets are changing at an accelerating pace and that we are living in a very dynamic, much more competitive world. There are more opportunities to raise money and deeper, more varied pools of capital in other countries than ever before. Even if SOX were provably and quantifiably a determinant in the increase in foreign market IPOs—and sound science does not permit such neat conclusions—the fact is there are simply greater competitive challenges than ever before to the United States’ leading position in the world as the largest, deepest, and most liquid markets.

Our continued global market leadership is not America's birthright. We have to constantly earn it. That is true for our private sector and it is true for our regulatory system. As regulators, we must constantly work to sharpen our competitive edge as well. When it comes to SOX, that has meant completely overhauling the expensive, inefficient auditing standard that was used to implement section 404. We recently repealed it and replaced it with a new standard that is clearly written in plain English, is less than half as long, and is risk-based, materiality-focused, and scalable for companies of different sizes. We expect it to dramatically reduce the costs of SOX 404 compliance.

That said, the evidence of some high profile foreign IPOs no longer listing in the United States may simply be an indication that other markets have improved, not that the United States has become unattractive. A steady stream of foreign companies continues to tap the U.S. markets. In fact, according to Thomson Financial, this year is on pace to add the most foreign listings on U.S. exchanges since 1997. It was also recently reported that foreign companies accounted for 23.4 percent of IPO proceeds last year—the highest amount since 1994.

Question. Chairman Cox, the press has reported that the SEC intends to put forward its management guidance in the next few weeks. Can you comment on the timeline to putting forth this guidance and the process for its adoption?

Answer. On May 23, 2007, the Commission unanimously approved interpretive guidance to help public companies strengthen their internal control over financial reporting while reducing unnecessary costs, particularly at smaller companies. The new guidance will enhance compliance under Section 404 of the Sarbanes-Oxley Act of 2002 by focusing company management on the internal controls that best protect against the risk of a material financial misstatement. It is currently in effect.

The Commission also approved rule amendments providing that a company that performs an evaluation of internal control in accordance with the interpretive guidance satisfies the annual evaluation required by Exchange Act Rules 13a-15 and 15d-15. The Commission also amended its rules to define the term "material weakness" as "a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis." The Commission also voted to revise the requirements regarding the auditor's attestation report on the effectiveness of internal control over financial reporting to more clearly convey that the auditor is not evaluating management's evaluation process but is opining directly on internal control over financial reporting. These changes, too, are now in effect.

In addition, the SEC in July 2007 repealed the costly Auditing Standard No. 2, which had made Sarbanes-Oxley compliance so difficult, and replaced it with a completely new standard that is top down, risk-based, materiality focused, and scalable for companies of all sizes. The replacement standard, Auditing Standard No. 5, is now in effect.

Question. The data shows that smaller public companies have experienced a disproportionate burden from Sarbanes-Oxley. Given that you are re-writing the rulebook for management, are you going to do anything to grant further relief for the non-accelerated filers? Some of my colleagues (Sen. Snowe and Sen. Kerry) have called for delayed implementation of the Sarbanes-Oxley Section 404 requirements for small public firms to ease the burden on complying with the expected new auditing standards.

Answer. The question of further deferral for non-accelerated filers is still open. The SEC has, however, already deferred compliance for non-accelerated filers four times in an effort to ensure that the burden of compliance did not unduly impact smaller companies. The very positive result of our determination to phase in 404 for smaller companies is that we and they have had the opportunity to field test the requirements so that smaller companies have the benefit of learning from the experiences of larger firms.

These experiences have deeply informed the SEC's new Interpretive Guidance and the PCAOB's new auditing standard. The continued phased implementation will allow smaller firms to start complying with section 404(a) of SOX starting in 2008, while the first audit under section 404(b) won't be due until 2009.

The SEC's new guidance is intended to be of significant help to small companies. Completing the implementation of Section 404 is important to further enhancing the quality of reporting and increasing investor confidence in the fairness and integrity of the securities markets. The Commission and the PCAOB will continue our ongoing outreach efforts over the coming months to ensure that the changes recently made in the implementation of section 404 live up to our expectations for a more effective and efficient system for all filers. In particular, we will focus on the extent

of the expected cost reductions for first-time accelerated filers during 2008 under the new Auditing Standard No. 5 and our new Interpretive Guidance.

Question. The majority of the problems with Sarbanes-Oxley have been the implementation—not the language itself. What is the SEC going to do to ensure that the fixes put forward in its new guidance are successfully implemented in order to bring the cost-benefit back into alignment?

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

Question. I understand that, due to concerns about the burdensome effects of section 404 of Sarbanes-Oxley, the Chamber of Commerce has asked that you delay 404 compliance for smaller public companies. Do you plan to delay 404 compliance? How can you limit the burden of section 404 on small companies?

Answer. With respect to the potential for a further delay of 404 compliance for smaller public companies, see the answer to Question 4, above. With respect to other ways that the SEC can reduce the burden of section 404 on small companies, we have very recently approved Interpretive Guidance recognizes that smaller public companies generally have less complex internal control systems than larger public companies.¹ The new Interpretive Guidance is intended to assist management of smaller companies in scaling and tailoring their evaluation methods and procedures, recognizing that what is necessary in a large company may not be appropriate for smaller companies with less complex internal controls systems.

The Interpretive Guidance is intended to allow management sufficient and appropriate flexibility to design an evaluation process that fits its facts and circumstances. We are encouraging smaller public companies to take advantage of the flexibility and scalability afforded in the guidance to conduct an evaluation of internal controls that is both efficient and effective at identifying material weaknesses.

In order to help smaller companies understand how they can tailor their evaluation efforts, the guidance specifically highlights some of the key areas where the evaluation at a smaller company might be different than for a larger company. For example, three key points within the evaluation process are the overall determination of effectiveness of the design of controls, the testing of the operating effectiveness, and the documentation needed to sufficiently support both. The Interpretive Guidance includes guidance on each of those points indicating how a smaller company may accomplish those requirements of the evaluation process.

The guidance explains how a small company might approach 404 differently than a large company. For example:

- A smaller company would probably follow fewer and different steps in evaluating whether its controls will provide reasonable assurance about the reliability of its financial reports.
- Management in a smaller company can go about obtaining information on whether its controls operate as designed in different and less elaborate ways than would be necessary in a large company.
- The documentation needed to provide reasonable support for a smaller company's controls will normally be less than what's required in a larger company.

Question. The Chamber of Commerce has asked that you clarify a number of defined terms so that companies have better guidance about what is required of them to comply with section 404. These terms include “material weakness,” “significant deficiency,” and “materiality.” Have you further clarified the use of these terms?

Answer. On May 23, 2007, the Commission adopted amendments to its rules to define the term “material weakness” as “a deficiency, or combination of deficiencies, in internal control over financial reporting (ICFR), such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.” Our intention

¹*Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission* (Apr. 23, 2006) at 39–40, (“Advisory Committee Report”) available at <http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf>.

is to re-focus 404 compliance on the specific problem that Congress had in mind: material risks to reliable financial reporting. In that way, we will better protect investors and companies can more wisely spend their money on meaningful evaluations of internal controls. In addition, the definition of material weakness, including the indicators of material weakness, has been aligned between the Commission's management guidance and the PCAOB's Auditing Standard No. 5 to promote consistency in the considerations made by management and auditors in evaluating deficiencies.

In addition, on June 20, 2007, the Commission issued a release seeking additional comment on a proposed definition of a "significant deficiency." The proposal defines "significant deficiency" as "a deficiency, or combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of a registrant's financial reporting." In drafting the proposed definition, we considered comments received by the PCAOB in response to its proposed auditing standard. We believe that the proposed definition reflects the Commission's belief that the focus of the term "significant deficiency" should be the underlying communication requirement that results between management, audit committees and independent auditors. The comment period on this proposal ends on July 18, 2007 and we will evaluate comments received to ensure that the final definition effectively communicates the Commission's objectives.

With regards to materiality, both the SEC and PCAOB received a number of comments, including those received from the Chamber of Commerce, suggesting that more guidance should be issued related to materiality and how it applies to the evaluation and assessment of ICFR. For management, judgments regarding materiality often must consider many factors that can vary based on each company's individual facts and circumstances. These areas are frequently complex and involve significant judgment, which makes providing "bright-line" guidance and examples difficult and presents the risk of unduly restricting management's ability to effectively utilize and apply its informed judgment. Nonetheless, we are continuing to seek feedback on the more challenging issues relative to materiality considerations and the appropriateness of providing additional guidance.

Question. Past chairman of the National Venture Capital Association, Robert Grady, wrote a few weeks ago that section 404 is causing an outcry because it requires "tiny companies to provide shelf after shelf of process-oriented paperwork, at the cost of millions of dollars, that no investor is even likely to read." Do you agree with this assessment? How can we—as Grady says—"bring sanity to this process?"

Answer. The SEC is keenly attuned to making sure that the U.S. capital markets remain robust and competitive, and to helping small businesses remain competitive in the global marketplace. To date, no tiny company—this is, no company with public float of less than \$75 million—has had to comply with section 404.

To "bring sanity to this process," as Mr. Grady suggests, the SEC is working to make sure that its regulations are scalable and that they do not impose an undue burden on small businesses. In May 2007, the SEC proposed and adopted a number of changes—in the way private offerings are conducted in the United States, and in the section 404 internal controls reports that companies are required to file with us—that address both scalability and competitiveness.

We continually review our regulations with a view towards reducing the burdens of being a public company and to remove obstacles to raising capital, consistent with investor protection. On May 23 the Commission approved an entire package of rule change proposals designed to modernize and streamline capital raising and reporting requirements affecting small business. The small business improvements that the SEC recently proposed include:

- Giving small businesses access to the expedited "shelf" registration process for their own securities offerings, which previously was available only to big companies.
- Cutting paperwork for thousands of small businesses, by allowing them to raise capital in a private offering after filing a simplified Form D online.
- Establishing shortened holding periods for restricted securities, making it easier for small business shareholders to put their securities on the market sooner and hopefully reducing the discount that small businesses must absorb to sell restricted securities.
- Giving issuers the benefit of a new, limited offering exemption from Securities Act registration requirements for offerings and sales of securities to a newly defined category of "qualified purchasers" in which limited advertising would be permitted.
- Eliminating the limit on the number of employees who can receive stock options from their fast-growing private firms, improving the ability of emerging growth

companies to attract and retain talent without prematurely triggering the requirements of the Exchange Act.

—Providing a simplified system of disclosure for almost 1,600 additional smaller public companies, an increase of over 45 percent in the number of small companies that are currently eligible.

Many of these rule proposals address key recommendations made by the Commission's Advisory Committee on Smaller Public Companies. We look forward to further input from the small business community as we receive the public comments on those proposals. We will continue to consider additional recommendations made by the Advisory Committee.

Question. A new undertaking of the SEC is the oversight of credit rating agencies. Could you please tell me a little bit more about this and what led the SEC to begin this new project?

Answer. On May 23, 2007, the Commission voted to adopt final rules to implement provisions of the Credit Rating Agency Reform Act of 2006, which was enacted into law in September 2006. The Credit Rating Agency Reform Act defines the term "nationally recognized statistical rating organization" (NRSRO), provides authority for the Commission to implement registration, recordkeeping, financial reporting, and oversight rules with respect to registered credit rating agencies. The Commission acted well in advance of the statutory deadline to establish the regulatory regime for rating agencies and to lower the barriers to entry into this market.

The goal of this new law is to improve credit ratings quality by fostering competition, accountability, and transparency in the credit rating industry. The heart of the Act calls on the Commission to replace the barriers to entry that had previously existed. The replacement is a transparent and voluntary Commission registration system that favors no particular business model. The SEC adopted rules in each of these areas that would implement the Credit Rating Agency Reform Act.

Question. What are the methods of enforcement used against violators of federal securities laws?

Answer. Investigations begin when the staff obtains information from any of a wide range of sources about a possible violation of the securities laws. Sources include the surveillance units at the exchanges, examinations of regulated entities, issuer filings, news reports, and investor complaints. When the staff first obtains a lead, it conducts a preliminary inquiry. If the lead seems promising, the staff opens an informal investigation and requests voluntary submission of documents and sworn testimony from witnesses. If the staff cannot obtain documents or testimony voluntarily, the Commission can issue a formal order of investigation, which authorizes the staff to issue subpoenas for testimony and the production of documents. If an investigation uncovers evidence of wrongdoing, the staff meets with the Commission, presents a description of the case, suggests what action is appropriate and discusses various alternatives. The Commission may then authorize the staff to begin public enforcement action in a federal district court or before a Commission administrative law judge. The Commission may also accept proposals submitted by the alleged violator to settle the proposed charges.

The securities laws provide for a broad range of sanctions, including: cease-and-desist orders, censures, injunctive relief, disgorgement, civil penalties, and industry bars. Moreover, civil monetary penalties may be imposed in cases involving repeat violations and severe frauds. The Commission's full range of existing remedies ensure that the Commission can effectively prosecute cases. This is particularly true given the SEC's ability to make criminal referrals in the most egregious cases.

Question. Commissioner Cox, would you please explain how the SEC cooperates with foreign authorities especially regarding cross-border enforcement?

Answer. Because fraudsters take advantage of borderless capital markets, the SEC requests assistance from foreign counterparts in all types of investigation—from fraud committed by investment advisers, to market manipulation schemes, to account intrusion cases, to international insider trading rings. To promote information sharing in cross-border securities investigations, the SEC was a founding member of the International Organization of Securities Commissions (IOSCO), and supported IOSCO's endorsement of the Multilateral Memorandum of Understanding (MMOU) in 2002. The MMOU requires signatories to meet international standards for international enforcement cooperation. The growing number of signatories to the MMOU is strong evidence of the increasing ability of our foreign colleagues to assist in international investigations. In fact, a number of foreign counterparts have strengthened their laws in order to be able to meet the international standard required to join the MMOU and thus be considered among the responsible members of the international enforcement community. As of September 2006, 34 securities and derivatives regulators had become signatories to the MMOU, and 9 additional IOSCO members had expressed their commitment to become signatories.

We are also witnessing an increase in the number of investigations (and, consequently, the number of requests for assistance) in major capital markets, such as Canada and Australia, with enforcement programs similar to our own. We are also seeing fervent enforcement efforts in other less developed markets. Some of the nations whose markets are emerging, whose enforcement laws are newly minted or strengthened, or whose regulatory agencies are recently established are keen to establish robust enforcement programs. The tremendous demand for the SEC to send staff to train foreign investigators demonstrates our counterparts' interest in effective enforcement and in combating securities fraud. In response, the SEC conducts technical assistance and training which, over the course of close to 20 years, has resulted in more effective enforcement programs around the world.

The most prominent type of illegal activity as to which our foreign counterparts seek assistance is in the area of insider trading. In the past 13 months, the SEC has received over 50 requests from our foreign counterparts to assist in insider trading investigations. During this same time frame, we have also received a substantial number of requests from abroad seeking assistance in market manipulation investigations (that is, cases where fraudsters may have manipulated the market price of a company's stock by false representations about the company or by illegal trading in the stock.)

CONCLUSION OF HEARINGS

Senator DURBIN. This meeting of the subcommittee will stand recessed.

[Whereupon, at 3:58 p.m., Wednesday, May 16, the hearings were concluded, and the subcommittee was recessed, to reconvene subject to the call of the Chair.]

Material Submitted Subsequent to the Hearings

FEDERAL DEPOSIT INSURANCE CORPORATION

PREPARED STATEMENT OF JON T. RYMER, INSPECTOR GENERAL, OFFICE OF THE
INSPECTOR GENERAL

Mr. Chairman and Members of the Subcommittee: I am pleased to present the fiscal year 2008 budget request totaling \$26.8 million for the Office of Inspector General (OIG) at the Federal Deposit Insurance Corporation (FDIC), the first budget request since I took office on July 5, 2006. This request will allow us to continue meeting our statutory responsibilities and assist the FDIC in effectively carrying out its mission.

As you know, the Congress created the FDIC in 1933 as an independent executive agency, during the Great Depression, to maintain stability and public confidence in the nation's banking system. Our nation has weathered several economic downturns since that era without the severe panic and loss of life savings unfortunately experienced in those times. The federal deposit insurance offered by the FDIC is designed to protect depositors from losses due to failures of insured commercial banks and thrifts. The Congress enacted deposit insurance reform legislation that will maintain insurance coverage for individual accounts at \$100,000, but provides for inflation indexing every 5 years beginning in 2011. Also, as of April 1, 2006, coverage for certain retirement accounts increased to \$250,000 from \$100,000, with similar inflation indexing. According to most recent FDIC data, as of December 31, 2006, the FDIC insured \$6.6 trillion in deposits for 8,693 institutions, of which the FDIC supervised 5,220. The FDIC promotes the safety and soundness of these institutions by identifying, monitoring, and addressing risks to which they are exposed.

The Corporation reports that industry earnings are at record-high levels, bank capital is historically high, and loan performance has slipped only slightly from record levels. Currently, there are 50 institutions on the "problem list"—one of the lowest numbers in the history of the FDIC. Unfortunately, the 31-month streak of no failures—the longest in FDIC history—ended in February 2007, when one small institution, Metropolitan Savings Bank, failed. Still, the financial health of the banking industry remains very good overall. As for the economy, it is now in a sixth year of expansion; however, U.S. economic growth appears to be slowing significantly and some negative trends are emerging in the banking sector. They include a narrowing of net interest margins; increasing concentrations of riskier commercial real estate loans; and signs of credit distress in subprime mortgage portfolios. As economic conditions shift, the OIG is poised to focus its work on the challenges facing the FDIC in monitoring and assessing various existing and emerging risks to insured depository institutions and the Deposit Insurance Fund.

The FDIC OIG is an independent and objective unit established under the Inspector General Act of 1978, as amended. The OIG's mission is to promote the economy, efficiency, and effectiveness of FDIC programs and operations, and protect against fraud, waste, and abuse to assist and augment the FDIC's contribution to stability and public confidence in the nation's financial system.

Before discussing our budget needs for fiscal year 2008, I would like to highlight some of our accomplishments from the past fiscal year, our assistance to FDIC management, our planning and internal initiatives to improve the OIG, and the management and performance challenges facing the FDIC.

A REVIEW OF THE FDIC OIG'S FISCAL YEAR 2006 ACCOMPLISHMENTS

As in past years, during fiscal year 2006, our work in audits, evaluations, and investigations resulted in a number of major achievements, as follows: \$44.9 million in actual and potential monetary benefits; 26 audit and evaluation reports issued; 82 non-monetary recommendations to FDIC management; 49 referrals to the Department of Justice; 42 indictments/informations; 26 convictions; 1 employee/disciplinary action.

More specifically, our accomplishments included investigations that led to the above indictments and convictions as well as fines, court-ordered restitution, and recoveries that constitute slightly over \$39 million in actual and potential monetary benefits from our work. Our audit and evaluation reports included about \$3.4 million in questioned costs and \$1.5 million in recommendations that funds be put to better use. The audit and evaluation reports contained non-monetary recommendations to improve FDIC policies, operations, and controls that ultimately are designed to improve the FDIC's ability to effectively and efficiently accomplish its mission.

On the whole, the OIG accomplished all of its organizational goals during the fiscal year, as outlined in our annual performance plan. Our 2006 Performance Report shows that we met or substantially met 100 percent of our goals. In a measurable way, this achievement shows the progress we continue to make in adding value to the Corporation with our audits, investigations, and evaluations in terms of impact, quality, productivity, and timeliness.

The following audit, evaluation, and investigative work illustrates some of the OIG's accomplishments in fiscal year 2006:

- Audit reports addressed significant issues. For example, one report contained recommendations to ensure that the FDIC periodically validates key assumptions, estimates, or other components that factor into the calculation of the reserve ratio, which is the ratio of the balance in the Deposit Insurance Fund to estimated deposits in the banking system. In connection with corporate governance practices, this report also recommended improved communication of information relevant to deposit insurance assessment determinations and other corporate matters and activities to the FDIC Board of Directors. Several reports dealt with various consumer protection and community reinvestment issues, including predatory lending, use of Home Mortgage Disclosure Act data to identify and assess instances of potential discrimination in FDIC-supervised institutions, and the FDIC's process for addressing the violations and deficiencies reported in compliance examinations. Our Federal Information Security Management Act-related audits have contributed to the FDIC making significant progress in the past several years in improving security controls and addressing current and emerging information security requirements.
- Evaluation reports focused on a number of important corporate issues, including the industrial loan company application process, the FDIC's safeguards over personal information, contract administration, and the FDIC's emergency response plan. The reports have generally contributed to strengthened program controls and improved corporate governance of FDIC operations.

Successful investigative outcomes included the following:

- The former president and chief executive officer of Hawkeye State Bank (HSB) was ordered to pay \$3.7 million in restitution based on his stipulating to having caused \$4.9 million in losses to HSB. He was sentenced to 65 months of incarceration and 5 years of supervised release.
- The former president of the First National Bank of Blanchardville was sentenced to 9 years' incarceration and ordered to pay restitution of \$13 million to the FDIC.
- The former chairman of the board and chief executive officer of Hamilton Bank was sentenced to 30 years of incarceration and 36 months of supervised release. He had earlier been convicted on all 16 charges of making false filings to the Securities and Exchange Commission and to bank examiners, making false statements, wire fraud, bank fraud, securities fraud, obstruction of a bank examination, and conspiracy. He, along with two other convicted Hamilton Bank officers, was ordered to pay \$32 million in total restitution for bank and securities fraud, \$16 million of which is payable to the FDIC.
- The former chief executive officer (CEO) of the now defunct Sunbelt Savings and Loan of Dallas, Texas, an institution whose insolvency cost taxpayers approximately \$1.2 billion, was sentenced to 15 years' imprisonment and ordered to pay a criminal forfeiture of \$2 million to the United States Government and restitution in the amount of \$312,828 to the FDIC. The former CEO was convicted on 27 counts involving defrauding the FDIC of its payments of \$7.5 million and \$8.5 million in a civil judgment resulting from his 1990 guilty plea to federal fraud charges in connection with the collapse of Sunbelt.

ASSISTANCE TO FDIC MANAGEMENT

In addition to audits, investigations, and evaluations, the OIG made valuable contributions to the FDIC in several other ways. Among these contributions were the following activities:

- Reviewed 14 proposed corporate policies and offered comments and suggestions when appropriate (e.g., Employee Rights and Responsibilities under the Privacy Act of 1974, Encryption and Digital Signatures for Electronic Mail, Protection of Privacy Information, the FDIC's Software Configuration Management Program, and Enterprise Risk Management);
- Participated in division-level conferences and meetings to communicate our audit, evaluation, and investigation work and processes;
- Provided technical assistance and advice to several FDIC groups working on information technology issues, including participating at the FDIC's information technology security meetings;
- Reviewed and/or commented on four draft legislative documents and regulations.

We are committed to continuing to demonstrate to the Congress, the public, the FDIC, and the banking industry that the OIG is doing the right things and generating results that are a worthy return on the investment made in us.

OIG PLANNING AND INTERNAL INITIATIVES

In fiscal year 2006, we undertook a comprehensive and integrated approach to planning OIG audits, evaluations, investigations, and internal activities, resulting in a Business Plan that captures our strategic goals, performance goals, and key efforts. We have been planning, conducting our work, and reporting our results in the context of these strategic goals since that time and will continue to do so in fiscal years 2007 and 2008. The OIG's work is centered on five strategic goals that link directly to the FDIC's mission, principal business lines, and significant challenges: Supervision, Insurance, Consumer Protection, Receivership Management, and Internal Resources Management. To these, we added a goal related to our internal processes in the interest of continuing to build and sustain a high-quality OIG work environment. We are pursuing that goal intently through a number of operational improvement projects.

These projects include professional development; human capital management and leadership development; client, stakeholder, and staff relationships; quality and efficiency of OIG work; strategic and annual performance planning and measurement; and information technology. These initiatives are important for the OIG to ensure that we build and sustain the quality of our work and remain a results oriented high-performance organization, use our resources wisely, and stay abreast of the significant and ever-changing challenges facing the FDIC and the financial services industry.

The complete 2007 Business Plan can be found on our Web page at <http://fdicig.gov> or obtained by contacting our office. Consistent with our working Business Plan, we are currently developing performance goals and key efforts for fiscal years 2008 and 2009, which will continue building on our six strategic goals. We will also continue to coordinate closely with the Congress, FDIC management, financial regulatory OIGs, others in the IG community, the U.S. Government Accountability Office, and law enforcement agencies as we plan and conduct our upcoming work.

MANAGEMENT AND PERFORMANCE CHALLENGES FACING THE CORPORATION

As part of our planning and budgeting process, the OIG annually assesses the most significant management and performance challenges facing the Corporation, in the spirit of the Reports Consolidation Act of 2000. In identifying those challenges, we consider the FDIC's strategic goals and the Chairman's corporate priorities and objectives. Identifying these challenges helps guide our work. In February 2007, we identified the following management and performance challenges facing the Corporation for inclusion in the Corporation's Performance and Accountability Report: addressing risks in large banks; maintaining strong regulatory capital standards; implementing deposit insurance reform; maintaining an effective examination and supervision program; granting insurance to and supervising industrial loan companies; guarding against financial crimes in insured institutions; safeguarding the privacy of consumer information; promoting fairness and inclusion in the delivery of information, products, and services to consumers and communities; ensuring compliance with consumer protection laws and regulations and follow-up on violations; being ready for potential institution failures; and promoting sound governance and managing and protecting human, financial, information technology, physical, and procurement resources.

FDIC Chairman Bair recently expressed her views on several challenges that the Corporation is facing and that she believes will continue to warrant attention over the next few years. The Chairman highlighted the following challenges as "front-burner" issues:

- Making sure the FDIC has a strong, vigilant supervisory program and creating a strong interrelationship between compliance and risk management;
- Implementing deposit insurance reform to help ensure a deposit insurance pricing system that reinforces the supervisory program;
- Maintaining strong regulatory capital standards under Basel II;
- Granting insurance to and supervising industrial loan companies;
- Promoting fairness and inclusion in the delivery of information, products, and services to consumers and communities; and
- Promoting sound governance and managing resources.

In addition to these priorities, Chairman Bair recently testified before the House Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services regarding other management and performance challenges facing the Corporation. Chairman Bair focused on the following:

- Strengthening protections available to borrowers in the subprime mortgage market; and
- Ensuring that predatory lending practices do not take root in the banking system.

Clearly, our assessment of corporate challenges and the Chairman's articulation of priority issues are closely aligned. We look forward to continuing to work with the Congress and corporate officials to address all of these challenges successfully.

OIG'S FISCAL YEAR 2008 REQUEST

Our fiscal year 2008 budget request seeks the resources necessary to allow the OIG to continue its efforts in audit, investigative, and evaluation work. In addition, our funding allows us to continue to enhance knowledge capacity, employee programs, and operational improvement projects. These funds are essential to helping us remain prepared to meet the complex issues and challenges confronting the FDIC. The funds are critical to ensure that OIG can continue to provide our clients with timely, objective, and reliable information on how well FDIC programs, operations, and policies are working, and, when needed, recommendations for improvement. The OIG is an invaluable tool for helping the FDIC protect against fraud, waste, and abuse to assist and augment the Corporation's contribution to stability and public confidence in the nation's financial system.

At this time, we anticipate handling a 2008 investigative workload comparable to that of 2007. With respect to 2008 audit and evaluation work, we also anticipate a similar level of effort, with sustained attention to many of the Chairman's corporate priorities. Some key efforts begun in fiscal year 2007 will carry over into fiscal year 2008. To remain responsive to ever-changing priorities and emerging issues, we will keep close track of our planned work and make adjustments, as needed, to maximize the value that we add.

After 11 years of consecutive budgetary decreases, our fiscal year 2008 budget request in the amount of \$26,848,000 represents a modest increase of \$592,000 (or 2.2 percent) over our fiscal year 2007 funding level. This budget request reflects a stabilized OIG operating environment and will support a full-time equivalent staff of 127, down 3 from fiscal year 2007. Even with the reduction in staffing, the slight increase in budget is required to help absorb higher projected expenses for employee salaries and benefits costs and non-personnel related expenses. As in past years, funds for the OIG budget would be derived from the Deposit Insurance Fund and the Federal Savings and Loan Insurance Corporation Resolution Fund.

CONCLUDING REMARKS

I appreciate the support and resources we have received from this Subcommittee, the Congress, and the FDIC. As a result, the OIG has continued to pursue successful investigations and to make a difference in FDIC operations in terms of financial benefits and improvements and strengthened internal operations and efficiency. I look forward to continue working with this Subcommittee in years to come. I believe our fiscal year 2008 budget strikes an appropriate balance between the mandate of the Inspector General Act, other legislative requirements, our judgments of OIG workload needs, and the changing conditions in the banking industry. We continue to seek your support so that we will be able to effectively and efficiently conduct our work on behalf of the Congress, the FDIC, and the American public.

NONDEPARTMENTAL WITNESS

PREPARED STATEMENT OF INDEPENDENT SECTOR

Mr. Chairman and Members of the Committee: Independent Sector appreciates the opportunity to comment on fiscal year 2008 federal appropriations for Internal Revenue Service activities.

Independent Sector is a nonprofit, nonpartisan coalition of approximately 575 charities, foundations, and corporate philanthropy programs, collectively representing tens of thousands of charitable groups in every state across the nation. Our mission is to advance the common good by leading, strengthening, and mobilizing the charitable community. We have worked since our inception to help our member organizations meet the highest standards of ethical practice, accountability, and effectiveness.

We support increased funding of the Internal Revenue Service's fiscal year 2008 budget and write today to urge you to appropriate the level recommended by the IRS Oversight Board: \$11.406 billion, \$310.1 million above the President's budget request.¹ The increased funding is necessary to develop more effective oversight and enforcement of the laws regulating charities and foundations as well as comprehensive education of nonprofit organizations about their obligations under those laws.

An Ethical, Accountable Nonprofit Community is Essential to Nonprofits' Ability to Improve Lives

Our country's growing nonprofit community works to improve lives in communities across America and around the world. It provides vital services in such fields as health, education, social assistance, community development, and the arts.

Crucial to fulfilling our missions is our ability to demonstrate to our stakeholders—donors, beneficiaries, volunteers, and policymakers—that we operate ethically and accountably. Only if we earn and maintain their trust will we receive their continued support. Preservation of that trust depends upon a combination of vigorous self-regulation by charitable organizations and effective enforcement of the law.

In recent years, media stories have revealed a number of instances of abuse by taxpayers using charitable organizations for personal gain and individuals claiming excessive contributions. Former IRS Commissioner Mark Everson encapsulated this threat in testimony before Senate appropriators in April 2005, “[i]f we do not act expeditiously, there is a risk that Americans will lose faith in our nation's charitable organizations. If that happens, Americans will stop giving and those in need will suffer.”²

Concerned about the cumulative impact of abuse and convinced of the need for better enforcement, in 2004, at the encouragement of the Chairman and Ranking Member of the Senate Finance Committee, Independent Sector brought together leaders from all corners of the nonprofit community to create the Panel on the Nonprofit Sector. The Panel was charged with considering and recommending actions to ensure that charities and foundations maintain the highest possible ethical standards. It submitted its Final Report to Congress and the Nonprofit Sector³ in June 2005 proposing more than 120 actions to be taken by charitable organizations, Congress, and the IRS.

A key recommendation of the Panel is to increase resources allocated to the IRS for oversight of charitable organizations as well as overall tax enforcement. As noted by the Panel, effective oversight of the nonprofit community requires vigorous enforcement of the law. It continued, “without adequate resources for oversight and enforcement, those who willfully violate the law will continue to do so with impunity.”⁴

Comptroller General David Walker echoed the Panel's recommendation in congressional testimony in 2005: “Oversight can help sustain public faith in the sector and ensure that exempt entities stay true to the purposes that justify their tax ex-

¹IRS Oversight Board, “Fiscal Year 2008 IRS Budget Recommendation, Special Report,” at 13 (April 2007).

²Hearing on Internal Revenue Service Fiscal Year 2006 Budget Request Before the Senate Comm. on Appropriations, Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies, 109th Cong. 8 (2005) (statement of Mark W. Everson, Commissioner, Internal Revenue Service).

³Panel on the Nonprofit Sector, “Strengthening Transparency, Governance, and Accountability of Charitable Organizations: A Final Report to Congress and the Nonprofit Sector,” available at http://www.nonprofitpanel.org/final/Panel_Final_Report.pdf (June 2005).

⁴Id. at 25.

emption. It also can help protect the entire sector from potential abuses initiated by a small minority.”⁵

Additional Resources are Needed to Restore and Grow IRS Enforcement Capacity

Following a dramatic decline in IRS enforcement resources during the 1990s, Congress has in recent years enacted targeted increases to the IRS budget. We applaud and appreciate these investments, which have enabled the IRS to initiate critical investigations into potential areas of noncompliance, including political intervention by nonprofits, executive compensation practices, and abuses by credit counseling agencies.

However, the IRS’s enforcement capacity has not yet fully rebounded. As the Government Accountability Office noted in a recent statement before this subcommittee, “[a]lthough IRS has increased direct revenue collected through its enforcement programs in recent years, enforcement continues to be included on our list of high-risk federal programs.”⁶

IRS enforcement resources have not kept pace with the dynamic growth of the nonprofit community. Over the past 20 years, the number of charities and foundations has nearly doubled in size, with applications for tax-exempt status increasing steadily. During that time period, the number of staff within the IRS Tax Exempt and Government Entities Division has remained essentially unchanged.⁷ In fiscal year 2006, the most recent year for which data is available, the IRS examined 34 percent fewer tax-exempt returns than it did in fiscal year 1997.⁸

The recent enactment of the Pension Protection Act of 2006 (Public Law No. 109–280) has put yet additional pressure on the IRS, making the need to strengthen the IRS more urgent. The Pension Protection Act (PPA) included what one IRS official has categorized as the most “significant, comprehensive legislation” affecting tax-exempt organizations since 1969.⁹ It contained various provisions, many of which reflected the recommendations of the Panel on the Nonprofit Sector, designed to deter individuals who would use charitable organizations for personal benefit and to ensure that donations are used for charitable purposes.

Since enactment of PPA, the IRS has issued several pieces of guidance implementing and explaining the new law. However, much more has yet to be done. For example, PPA mandated that the IRS complete a study on supporting organizations and donor-advised funds by August 2007. The IRS has additionally pledged to develop guidance on a number of issues in the coming year as well as to continue efforts to overhaul the Form 990, the annual Return of Organization Exempt From Income Tax, to reflect new filing requirements enacted as part of PPA as well as other much-needed modifications.

Recognizing the importance of building staff capacity and stronger enforcement mechanisms, the Administration requested in its fiscal year 2008 budget funding to support 12 IRS enforcement initiatives, including a program to increase tax-exempt entity compliance. Echoing the IRS Oversight Board, we applaud the President’s commitment to restoring and strengthening the oversight capacity of the IRS. However, we urge you to fund the initiatives at the level recommended by the Board—\$351.4 million, or \$105 million above the President’s request.¹⁰ Increased funding will better equip the IRS to serve its enforcement functions—to ensure nonprofits meet the requirements of the tax laws, in particular the new mandates included in PPA, and help to protect charitable organizations from unscrupulous individuals looking to exploit them for personal gain.

Education and Outreach are Needed to Enhance Voluntary Compliance

As articulated in its guiding principle—“service plus enforcement equals compliance”—the IRS will only achieve maximum compliance with our nation’s tax laws

⁵Tax-Exempt Sector—Governance, Transparency, and Oversight are Critical For Maintaining Public Trust: Hearing on an Overview of the Tax-Exempt Sector Before the House Comm. on Ways and Means, 109th Cong. 1 (2005) (statement of David M. Walker, Comptroller General of the United States, Government Accountability Office).

⁶Internal Revenue Service, Assessment of the 2008 Budget Request and an Update of 2007 Performance: Hearing on the Department of Treasury’s Budget Request and Justification for Fiscal Year 2008 Before the Senate Comm. on Appropriations Subcommittee on Financial Services and General Government, 110th Cong. 1 (2007) (statement of James R. White, Director, Strategic Issues, Government Accountability Office and David A. Powner, Director, Information Technology Management Issues, Government Accountability Office).

⁷Statement of David M. Walker, *supra* note 5, at 17.

⁸Internal Revenue Service, “Fiscal Year 2006 Enforcement and Service Results,” at 7 (November 20, 2006).

⁹Christopher Quay, *IRS Focusing on Forms, Education Issues Related to Pension Act, Official Says*, Tax Analysts, March 14, 2007, at Doc 2007–6377.

¹⁰IRS Oversight Board, *supra* note 1, at 17–19.

if it balances its oversight activities with a strong program of education, outreach, and accessibility.

Recent increases in the IRS budget have enabled the agency to develop myriad new educational tools for charitable organizations, including issue-specific teleconferences and web forums; an online training workshop, www.stayexempt.org; and numerous fact sheets and notifications. As in the enforcement arena, however, the passage of PPA makes additional IRS education crucial.

PPA increased the complexity of laws governing charitable organizations. Nonprofits will look to the IRS for explanation and guidance as they attempt to comply with these important new mandates. Tax practitioners too will turn to the IRS for technical guidance to ensure that they accurately and effectively advise their non-profit clients.

The large number of small organizations within the nonprofit community magnifies the need for stronger education. The majority of nonprofit organizations are community-based groups, many of which rely entirely on voluntary staff. Of the one million 501(c)(3) organizations registered with the IRS in 2004, approximately 63 percent had annual revenues of less than \$25,000 and were not required to file with the IRS. Of those obligated to file with the agency, nearly 63 percent reported total budgets of less than \$200,000.¹¹

PPA mandates a new reporting requirement for the smallest organizations, those with annual receipts of less than \$25,000. Failure to comply for three consecutive years will result in revocation of tax-exempt status. Oversight alone will not ensure these organizations—some 600,000 groups, the majority of which do not have access to tax and accounting advisers—comply with the law. It will be incumbent upon the IRS to find and notify these organizations of their new responsibility. The IRS Oversight Board's budget recommendation would enable the IRS to meet these service needs—to reach out to and educate nonprofit organizations that want to comply with the law but may not know how—while balancing its enforcement responsibilities.

CONCLUSION

Following a significant decline in resources, the Internal Revenue Service has made great strides toward restoring its tax enforcement program while maintaining adequate taxpayer services. This achievement is due in large measure to recent investments by Congress. We applaud and appreciate these efforts.

However, we concur with the recommendations of former IRS Commissioner Everson, the GAO, and others that additional resources are necessary to enable the IRS to continue to ensure effective oversight of the charitable sector and enforcement of our tax laws, while also maintaining taxpayer service. In order to help preserve and grow public trust in the nonprofit community's ability to improve lives and strengthen communities, we urge you to fund the IRS in fiscal year 2008 at the level recommended by the IRS Oversight Board: \$11.406 billion.

We thank you for your consideration of these comments. If you have any questions, please feel free to contact Patricia Read, Independent Sector's Senior Vice President of Public Policy and Government Affairs, by phone at (202) 467-6100 or by email at patr@independentsector.org.

¹¹Independent Sector analysis of the National Center for Charitable Statistics Core Data Files for Public Charities and Private Foundations. Analysis run on May 16, 2007. Internal Revenue Service, "Internal Revenue Service Data Book, 2006," at 56.