Testimony on the Fiscal Year 2016 Budget Request of the U.S. Securities and Exchange Commission

by

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Committee on Appropriations
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Chairman Crenshaw, Ranking Member Serrano, and members of the Subcommittee:

Thank you for inviting me to testify today in support of the President's fiscal year 2016 budget request for the Securities and Exchange Commission.[1] I appreciate the opportunity to describe the compelling basis for funding the agency at a level of $1.722 billion to help it fulfill its obligation to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.[2]

The U.S. securities markets are complex and constantly evolving, and the activities within our jurisdiction are not static. Understanding the growth in the size and complexity of the agency's responsibilities and in our markets, market participants, and investment products is critical to assessing the agency's funding needs. From fiscal year 2001 to the start of this fiscal year, for example:

- Assets under management of SEC-registered investment advisers increased approximately 254 percent from $17.5 trillion to approximately $62 trillion;

[1] A copy of the SEC's FY 2016 Congressional Budget Justification can be found on our website at http://www.sec.gov/about/reports/secfy16congbudgjust.shtml.

[2] The views expressed in this testimony are those of the Chair of the Securities and Exchange Commission and do not necessarily represent the views of the President, the full Commission, or any Commissioner. In accordance with past practice, the budget justification of the agency was submitted by the Chair and was not voted on by the full Commission.

- Assets under management of mutual funds grew by 143 percent from $6.4 trillion to $15.6 trillion; and

- Annual trading volume in the equity markets more than doubled to in excess of $67 trillion.

During this same period, the SEC's responsibilities have also dramatically increased, adding or expanding jurisdiction over securities-based swaps, private fund advisers, credit rating agencies, municipal advisors, and clearing agencies, among others. Improvements to technology and operations have made the agency more efficient and effective, but to continue to meet our mission, we must be able to keep pace with the current and growing size and complexity of our markets and the entities participating in them.

The agency today currently oversees more than 25,000 market participants, including nearly 12,000 investment advisers, approximately 10,500 mutual funds and exchange-traded funds, nearly 4,500 broker-dealers, and about 450 transfer agents. The agency also oversees 18 national securities exchanges, 10 credit rating agencies, and eight active registered clearing agencies, as well as the Public Company Accounting Oversight Board (PCAOB), Financial Industry Regulatory Authority (FINRA), Municipal Securities Rulemaking Board (MSRB), the Securities Investor Protection Corporation (SIPC), and the Financial Accounting Standards Board (FASB). The SEC also has responsibility for reviewing the disclosures and financial statements of approximately 9,000 reporting companies and for enforcing compliance with the federal securities laws.

The SEC's FY 2016 budget request seeks to address our current needs and the challenges we face by providing resources to allow the SEC to hire an additional 431 staff in critical, core areas and enhance our information technology. Specifically, as described in more detail below, the requested budget level would allow the SEC to advance several key and pressing priorities, including:

- Increasing examination coverage of investment advisers and other key entities who service retail and institutional investors;
- Further leveraging cutting-edge technology to permit the SEC to better keep pace with the entities and markets we regulate;
- Protecting investors by expanding our enforcement program's investigative capabilities and strengthening our ability to litigate against wrongdoers;
- Strengthening the SEC's economic and risk analysis functions; and
- Hiring additional market experts to enhance the agency's capability to fulfill its expanded and increasingly complex responsibilities.

As the Subcommittee is aware, the SEC's funding mechanism is deficit-neutral, which means that the amount Congress appropriates to the agency will not have an impact on the nation's budget deficit, nor will it impact the amount of funding available for other agencies.[3] Our appropriation also does not count against the caps set in the bi-partisan Congressional budget framework for 2015 and 2016. Nonetheless, I deeply appreciate that we have a serious responsibility to be an effective and prudent steward of the funds we are appropriated, and I believe we have demonstrated how seriously we take that responsibility.

Last year was one of important achievements for the SEC, but more remains to be done. Below is a summary of the accomplishments of the SEC in the past year and of the significant challenges ahead, as well as a more detailed description of key aspects of the FY 2016 budget request.

[3] Section 991 of the Dodd-Frank Act requires the SEC to collect transaction fees from self-regulatory organizations in an amount designed to directly offset our appropriation.

Significant Achievements, But More Remains

Since I testified before this Subcommittee last April, the SEC has accomplished a great deal in many areas important to our mission and in fulfilling Congressional mandates. Over the last year, informed and supported by rigorous and robust economic analyses, the Commission has adopted a series of critical reforms, including rules that directly respond to the financial crisis and that protect the integrity of our markets. We have made substantial progress implementing the rulemakings mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and the Jumpstart Our Business Startups Act (JOBS Act). The rules on which the Commission has taken action in the last year include:

- *Asset-Backed Securities.* The Commission completed rules requiring significant enhancements to registered offering disclosures for asset-backed securities, a market with $4.8 trillion in issuances over the past decade that includes the types of securities backed by residential and commercial real estate that played a central role in the financial crisis.

- *Credit Rating Agencies.* The Commission finalized over a dozen rules that will reduce conflicts of interest and strengthen the integrity of nationally recognized statistical ratings organizations and the transparency of their ratings. The Commission also continued to remove references to credit ratings, bringing the total of removed references to 30 and leaving only four rules and one form with references to be removed.

- *Money Market Funds.* The Commission completed reforms designed to enhance the structure and operation of the $3.7 trillion money market fund market to enhance the protection of investors and to support financial stability.

- *Security-Based Swaps.* The Commission proceeded with the next critical phase of its implementation of Title VII of the Dodd-Frank Act, adopting new rules for previously unregulated derivatives by mandating the parameters for covered entities and establishing registration and reporting requirements for security-based swap data repositories. In particular, in June 2014 the Commission adopted the threshold series of key rules and guidance on cross-border security-based swap activities for market participants, and earlier this year adopted rules that require security-based swap data repositories to register with the SEC and prescribe reporting and public dissemination requirements for security-based swap transaction data.

- *Capital Formation.* On March 25 of this year, the Commission voted to adopt a potentially transformative rule under the JOBS Act to significantly enhance the existing Regulation A exemption from registration for small offerings of securities. The

Commission also advanced rules to implement JOBS Act provisions concerning registration and reporting thresholds under Exchange Act Section 12(g).

- *Risk Retention.* As required by the Dodd-Frank Act, the Commission approved a joint agency rule requiring sponsors of securitization transactions to retain risk in those transactions.

- *Market Stability and Oversight.* The Commission adopted Regulation Systems Compliance and Integrity (Regulation SCI), creating for the first time mandatory technology and systems standards and reporting for significant market participants intended to reduce systems issues and improve the overall resiliency of our markets. On March 25 of this year, the Commission also voted to propose rule amendments to enhance the supervision of large proprietary trading firms, including those engaged in high frequency trading, which would require that broker-dealers trading in off-exchange venues become members of a national securities association.

- *Executive Compensation.* As required by the Dodd-Frank Act, the Commission proposed rules for enhancing corporate disclosure of hedging policies for officers and directors.

Progress has also been made in our assessment of U.S. equity market structure to ensure that our markets remain the deepest and fairest in the world and optimally serve investors and companies of all sizes seeking to raise capital. In addition to the adoption of Regulation SCI and the proposal to enhance the supervision of large proprietary trading firms, we have published for notice and comment a proposal by the self-regulatory organizations (SROs) for a pilot to assess the impact of different tick sizes on the quality of the equity markets for small capitalization issuers. In response to my request, the exchanges conducted and have now completed an in-depth analysis of order types and reported on their findings, and have filed proposed rule changes to improve disclosures about how they use securities information processor (SIP) feeds and direct feeds. The exchanges and SIPs, at my request, are also expected to incorporate by June a time stamp in their data feeds to facilitate greater transparency on the issue of data latency. And we have brought a number of significant enforcement actions for violations of market integrity rules, including against exchanges and dark pools.[4]

In addition, we have established an equity market structure advisory committee to focus on the structure and operations of the U.S. equities markets (including Regulation NMS) and provide a formal mechanism through which the Commission can receive advice and recommendations specifically related to equity market structure issues. The membership of the committee reflects a diversity of backgrounds, expertise, and viewpoints on our current equity market structure that we expect will provide valuable input as SEC staff continues to pursue a broad market structure agenda focused on high frequency trading and fairness, market transparency, trading venue regulation, mitigating broker conflicts, and critical market infrastructure. Staff also continues to pursue efforts to improve the market structure for trading fixed income securities, including municipal and corporate bonds, and is developing a far-ranging package of measures for enhancing the asset management industry's risk monitoring and regulatory safeguards.

We are also advancing our initiative to improve the effectiveness of the public company disclosure regime for investors and companies, where the staff has sought input from a broad range of market participants and is developing recommendations for the Commission's consideration. In addition, consistent with the Dodd-Frank Act, staff is currently engaged in a comprehensive review of the "accredited investor" definition.

[4] *E.g.*, Press Release No. 2014-263, *Wedbush Securities and Two Officials Agree to Settle SEC Case* (Nov. 20, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543504806; Press Release No. 2014-87, *SEC Charges NYSE, NYSE ARCA, and NYSE MKT for Repeated Failures to Operate in Accordance With Exchange Rules* (May 1, 2014), *available at* www.sec.gov/News/PressRelease/Detail/PressRelease/1370541706507; and Press Release No. 2014-114, *SEC Charges New York-Based Dark Pool Operator With Failing to Safeguard Confidential Trading Information* (June 6, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542011574.

The Division of Enforcement continued to achieve significant results, filing 755 enforcement actions and obtaining orders for more than $4.16 billion in disgorgement and penalties in fiscal year 2014. Notable actions include the first series of cases involving violations of the "market access" rule, the first action enforcing the rule against investment advisers participating in "pay to play" arrangements, the first action against a private equity firm relating to its allocation of fees and expenses, and the first anti-retaliation case to protect a whistleblower who reported improper trading activity. Structural and strategic enhancements – including increased recruitment of industry experts, the augmentation of our data analytics capacities, and bolstered new training programs – within our Office of Compliance, Inspections and Examinations have led to a more effective, efficient examination program.

Despite this and other significant progress, there is much that the SEC still needs to do: from further implementing our mandated rulemakings, to continuing the initiatives outlined above, to further strengthening our economic and risk analysis functions, to hiring additional market and quantitative experts to further address our expanded responsibilities, to continuing to improve our technology and operations to make the agency more agile and effective. Outlined below is a brief overview of some of the key components of our request.

Expanding Oversight of Investment Advisers and Strengthening Compliance

Our current level of resources is not sufficient to permit the SEC to adequately examine investment advisers in a way that investors expect and deserve. The number of registered advisers has increased nearly 35 percent over the last decade, and the assets managed by these advisers have more than doubled. At the same time, the industry has become more complex, as evidenced by the increasing use of new and sophisticated products such as derivatives and structured products; the increased use of technologies that facilitate high-frequency and algorithmic trading; and the growth of complex families of financial services by companies with integrated operations that include both broker-dealer and investment adviser affiliates.

Even with the SEC's efficient use of limited resources to improve its risk assessment capabilities and focus its examination staff on areas posing the greatest risk to investors – efforts that helped to increase the number of investment adviser examinations approximately 20 percent from FY 2013 – the SEC was only able to examine 10 percent of registered investment advisers in FY 2014. A rate of adviser examination coverage at that level presents a high risk to the investing public.

Under the FY 2016 request, a top priority will be to hire 225 additional examiners, primarily to conduct additional examinations of investment advisers. Once fully on-board and trained, the investment adviser examiners would assist the agency's National Examinations Program (NEP) in increasing its examination coverage of advisers to an anticipated rate of approximately 14 percent per year.

The NEP also would add positions to improve oversight and examination functions related to broker-dealers, clearing agencies, transfer agents, self-regulatory organizations, swap data repositories, municipal advisors, and, in the future, crowdfunding portals, among others.

Continue to Leverage Technology

In FY 2016, the SEC plans to build on the substantial progress made over the past few years to modernize its technology systems, streamline operations, and increase the effectiveness of its programs. The SEC's FY 2016 budget request, which includes full use of the Reserve Fund, would support a number of key information technology (IT) initiatives, including:

- *Data analytics tools*, to assist in the integration and analysis of huge volumes of financial market data, employing algorithms and quantitative models that can lead to earlier detection of fraud or suspicious behavior.

- *Electronic Data Gathering, Analysis and Retrieval (EDGAR) modernization*, an ongoing, multi-year effort to simplify the financial reporting process to promote automation and reduce filer burden. With a more modern EDGAR, both the investing public and SEC staff will benefit from having improved access to better data.

- *Examination improvements*, aimed toward improving risk assessment and surveillance tools that will help the staff monitor for trends and emerging fraud risks, as well as improving the workflow system supporting SEC examinations.

- *Tips, Complaints, and Referral (TCR) system enhancements*, to bolster the flexibility, agility, and adaptability of the system. TCR enhancements will provide more flexible and comprehensive intake, triage, resolution tracking, searching, and reporting functionalities, with full auditing capabilities.

- *Enforcement investigation and litigation tracking*, to support enforcement teams with handling the substantial volume of materials produced during investigations and litigations. Among other initiatives, the SEC hopes to build the capability to permit the electronic transmittal of data for tracking and loading (versus the current practice of receiving content via the mail); implement a document management system for Enforcement's internal case files; and revamp the tools used to collect trading data from market participants.

- *Enterprise Data Warehouse (EDW)*, a centralized repository for the SEC to organize its various sources of data and help SEC staff gain easier access to more usable market data. The EDW is the SEC's primary effort to bring together data from different divisions and offices for easier and more efficient analysis across the agency.

- *SEC.gov modernization*, to make one of the most widely used Federal Government websites more informative, easier to navigate, and secure for investors, public companies, registrants and the general public.

- *Information security*, to further automate controls, continue the transition to continuous monitoring, and build the agency's risk management capabilities.

- *Business process automation and improvement*, to build workflow applications that will improve the efficiency and effectiveness of the entire agency in serving the public.

The FY 2016 request includes 14 new positions for the Office of Information Technology (OIT) to better execute these and other technology initiatives. These staff will serve as project managers, business analysts, and technical resources who will improve technology and data management support for the SEC's business areas. In addition, the positions will enhance information security through monitoring, and drive further improvements in IT equipment management and reporting.

Bolster Enforcement

It is vital to the SEC's mission to bring timely, high-quality enforcement actions when violations of the federal securities laws are identified. The agency must adapt its enforcement function to keep pace with the growing size and complexity of the nation's markets and to send strong messages to wrongdoers that misconduct will be swiftly and aggressively addressed. For FY 2016, the SEC is requesting 93 new positions for the Division of Enforcement in three areas: staff proficient in conducting intelligence processing and analysis; investigative staff to permit the agency to more swiftly and effectively identify and respond to the high volume of securities-related misconduct; and litigation staff to address the growing number of contested enforcement matters nationwide.

Analysis of large datasets, including SEC filings and trading data in equities, options, municipal bonds, and other securities, helps to limit investor harm by permitting earlier detection of misconduct. The SEC's Enforcement program expects that both an increasing number of high-quality TCRs and its improved data analysis capabilities will yield additional case leads through FY 2016. The Enforcement program anticipates dedicating 20 of the requested positions to further develop its data analytic function, increase the number of staff responsible for reviewing and triaging incoming TCRs, and bolster the number of staff to whom TCRs are sent for further investigation.

The Enforcement program also requires increased staffing to promptly detect complex frauds and other difficult-to-detect misconduct; respond to misconduct involving the changing equity markets, including misconduct related to algorithmic trading or dark pools; address large-scale insider trading or stock manipulations; investigate potential accounting or reporting fraud; and generally keep pace with a rapidly growing and evolving industry. As a result, the Division is seeking 50 new positions in FY 2016 to reinforce its investigative functions. These new positions will help the Division continue progress on existing investigations and handle its increasing case load, while quickly investigating and bringing emergency actions in matters where investors' money may dissipate if immediate action is not taken.

In addition, in recent years an increasing percentage of enforcement actions have been filed as contested matters, as opposed to being fully settled at the outset. This has led to more trials than in the past, a volume that is expected to continue to grow. Therefore, the Enforcement program needs additional resources to handle an expansive and sophisticated docket of litigation and trials, often against well-funded adversaries. Enforcement requests 23 new positions in FY 2016 to reinforce its litigation operations nationwide.

Continued Prioritization of Economic and Risk Analysis to Support Rulemaking and Oversight

The SEC remains committed to strengthening the economic and risk analysis functions housed in its Division of Economic and Risk Analysis (DERA), our fastest growing division. For FY 2016, the SEC plans to add six new positions to DERA, building upon the 14 positions being added in FY 2015. Specifically, in FY 2016, DERA is seeking three positions to expand the agency's capability to provide high quality economic data in support of risk assessment and policy initiatives across the SEC. These employees would continue to expand DERA's ability to support SEC programs with data cleansing, normalization, and analysis; statistical programming, text analytics, and risk modeling; and quantitative research services. We are also requesting three additional positions for DERA to provide economic analytical capabilities to support enforcement litigation, particularly in the SEC's regional offices.

Meet Expanded Rulemaking and Oversight Responsibilities

The agency also is requesting 12 additional positions in FY 2016 for its Division of Trading and Markets (TM). As the SEC's oversight of regulated entities and analysis of market events become more data-driven, TM is expanding its use of advanced quantitative skills, tools, and data to assess evolving markets. The Division therefore is expanding its efforts to recruit professionals with expertise in quantitative analysis, risk management, and equity and fixed income market structure. The additional positions will enhance supervision of securities markets, securities market infrastructure, securities intermediaries, and other market participants. Recent legislation and rulemaking – including relating to over-the-counter derivatives, clearing agencies, and crowdfunding – also have substantially expanded TM's responsibilities. As registration requirements for these rules become effective, scores of new entities will require Division oversight.

In addition, the SEC is seeking 12 new positions for its Division of Investment Management to operationalize new rulemaking requirements, offer enhanced guidance to registrants, expand the disclosure review program's ongoing analysis of industry trends, and provide additional oversight of private fund advisers. The new positions would also monitor money market funds' compliance with the new requirements adopted in FY 2014 by the Commission, as well as assist in adopting – and ultimately operationalizing – the package of measures for enhancing the asset management industry's risk monitoring and regulatory safeguards.

Conclusion

Thank you for your support of the agency's vital mission and the opportunity to present the President's FY 2016 budget request. I would be happy to answer your questions.