U.S. SECURITIES AND EXCHANGE COMMISSION

FISCAL YEAR 2012 AGENCY FINANCIAL REPORT

About This Report

The U.S. Securities and Exchange Commission's (SEC) fiscal year (FY) 2012 Agency Financial Report (AFR) provides financial and high-level performance results that enable the President, Congress, and the public to assess the SEC's accomplishments and understand its financial picture. This report provides information that satisfies requirements contained in the following laws and regulations:

- Accountability of Tax Dollars Act of 2002
- Improper Payments Information Act of 2002, as amended
- Reports Consolidation Act of 2000
- Government Management Reform Act of 1994
- GPRA Modernization Act of 2010
- Federal Managers Financial Integrity Act of 1982
- Dodd-Frank Wall Street Reform and Consumer Protection Act Subtitle F. Sec. 963. Annual Financial Controls Audit and Sec. 922. Whistleblower Protection
- Office of Management and Budget Circular A-123, *Management's Responsibility for Internal Control*
- Office of Management and Budget Circular A-136, *Financial Reporting Requirements*

This year, the SEC is producing an AFR, with a primary focus on financial results, and an Annual Performance Report (APR), with a primary focus on strategic goals and performance results, in lieu of a combined Performance and Accountability Report. The FY 2012 APR will be included in the SEC FY 2014 Congressional Budget Justification in February 2013. An electronic version of the SEC FY 2012 AFR is available at *http://www.sec.gov/about/secafr2012.shtml.* To comment on or obtain a hard copy of the SEC's FY 2012 AFR, email SECAFR@sec.gov.

Contents

Available on the Web at *http://www.sec.gov/about/secafr2012.shtml*

To contact the SEC, please see *http://www.sec.gov* or "Contact Us" at *http://www.sec.gov/contact.shtml.*
For further information on selected terms and topics, please see "Fast Answers" at *http://www.sec.gov/answers.shtml*.

Message from the Chairman

In fiscal year 2012, the United States Securities and Exchange Commission further advanced its investor protection and market stability missions by fine-tuning its vigorous examination program, building on last year's extraordinary enforcement performance and pursuing a complex and urgent regulatory agenda. In addition, as a result of significant operational enhancements made in recent years, the agency was able to continue improving its performance and effectively manage a portfolio which has expanded dramatically as a result of financial reform legislation.

The results of this ongoing, strategic, multi-year effort to streamline and modernize can be seen across the agency. The Division of Enforcement brought a near-record number of actions and continued to lead the effort to hold responsible those who contributed to the financial crisis. Sophisticated targeting helped SEC examiners better uncover conduct that threatened or harmed investors. And the Commission proposed and adopted regulations that will make markets safer for retail investors and diminish the possibility of a future systemic crisis.

Building on a Record Year in Enforcement

In fiscal year 2012, the Division of Enforcement brought 734 enforcement actions – the second highest number of actions filed in a single year. In addition, the Division continued to hold accountable those whose actions contributed to the financial crisis. Overall, in connection with the financial crisis, the SEC has charged 117 entities and individuals including more than 50 CEOs, CFOs, and other senior corporate officers – and obtained over $2.2 billion in monetary relief, and imposed numerous professional and industry bars.

The Division also continued to ferret out insider trading, filing cases against financial professionals, hedge fund managers, and corporate insiders, many with direct ties to some of the nation's largest companies. In addition, the Division worked to ensure fair trading in the securities markets, stepping up its pursuit of compliance failures and rules violations related to stock exchanges, alternative trading systems, high-speed electronic trading firms, and other market participants.

The performance of the Division over the past year has been the result of strategic reforms now bearing fruit, including an expansion of in-house expertise, a flatter management structure, more streamlined processes, an increased use of information technology, and enhanced market intelligence capabilities. On the market intelligence front, for example, the Commission made its first award to a whistleblower under a new program that incentivizes insiders to provide information regarding securities law violations. The program stems from the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which called for the establishment of an Office of the Whistleblower. That office has seen a steady flow of high-quality tips and complaints, which are screened and triaged by the Division of Enforcement's Office of Market Intelligence.

Further, the Division is embracing new approaches and techniques to bolster its investigations, utilizing risk-based, proactive initiatives to identify emerging and hidden threats at an early stage so that actions can be brought quickly and investor harm minimized. Last year, for example, attorneys in the Division's Asset Management Unit detected and ended a fraudulent effort to use a popular social media site to sell $500 billion worth of fictitious "bank guarantees" and "medium-term notes" in hot tech offerings – *before* a single would-be investor was harmed. The Division uses these initiatives to bring enforcement actions and support investigations in a variety of areas, such as investment adviser fraud, microcap fraud, valuation, and conflicts of interest.

Similarly, efforts to break down silos among agency divisions and offices and to create a more collaborative culture led to – among other things – the creation of the Aberrational Performance Inquiry (API) team. API brought together multiple components of the agency to create and use proprietary risk analytics to identify and charge advisory firms and individuals with misconduct including improper use of fund assets, fraudulent valuations, and misrepresentation of fund returns.

Making the Exam Program Smarter

Over the past year, our National Examination Program (NEP) continued to develop as a crucial resource for the agency.

Among the improvements, the NEP has increased in-house expertise by hiring specialized subject matter experts on topics, such as derivatives, valuation of illiquid assets, and risk management; strengthened its training program; and established specialized working groups in key areas.

The NEP also has expanded its strategy of meeting with firms' independent board members, senior management, internal auditors, key risk and control function staff, and business line leaders to discuss how firms manage their financial, legal, compliance, operational, and reputational risks. In so doing, the NEP supports existing compliance efforts within individual firms and explores, in detail, issues that crop up across the financial service industry, working proactively to ensure compliance and protect investors' funds.

In addition, the NEP's newly-created Quantitative Analytics Unit coordinates with other offices within the SEC to refine methods of identifying risk, gathering and analyzing data, targeting examinations of investment advisers and investment companies, and supporting enforcement actions.

Continuing Operational Enhancements

In fiscal year 2012, the investing public continued to see performance gains stemming from improvements in the SEC's internal management processes instituted over the last several years. These improvements include updating and enhancing the accessibility of our SEC.gov website, improving our Freedom of Information Act practices, and using a remodeled contracting process to more effectively reach out to small businesses.

Additional internal reforms are making the agency more efficient in ways that the public may not recognize but which nonetheless improve agency responsiveness and generate financial efficiencies, such as improving the recruiting and hiring process and beginning a multi-year effort to streamline and integrate the agency's business processes.

Pursuing a Robust Regulatory Agenda

Investors will benefit from regulation and oversight efficiencies developed through the agency's rulemaking process in fiscal year 2012. One of last year's most important rulemakings requires the exchanges and the Financial Industry Regulatory Authority (FINRA) to establish a market-wide consolidated audit trail, which will give the SEC an unprecedented ability to monitor and analyze trading activity, detect fraudulent trading, and reconstruct unusual market behavior. The data generated by this trail will give the agency new insights into unusual market events, how changes in market structure affect trading patterns, and the potential effects of future policy choices.

The SEC also moved further along in creating an entirely new regulatory regime that will bring greater efficiency and transparency to the derivatives market – a huge market whose opaque structure helped freeze the credit markets in 2008, amplifying the financial crisis. The SEC now has proposed or adopted substantially all of the rules needed to create the new regulatory system.

In response to a 2011 rule, in fiscal year 2012 the agency announced that more than 1,400 new advisers to major hedge funds and other private funds had registered with the agency and begun reporting information which the SEC will share with the Financial Stability Oversight Commission, the inter-agency body charged with reducing the potential for systemically risky behavior by major financial institutions.

Together with other financial regulatory agencies, the SEC proposed rules implementing the so-called "Volcker Rule," which prohibits federally insured depository institutions from engaging in proprietary trading which might put taxpayer dollars and consumer accounts at risk.

Other significant rulemakings addressed emerging threats to investors, particularly retail investors whose access to information and ability to respond quickly to market conditions often lags behind those of professional traders and institutional investors.

For instance, after discovering accounting irregularities at a number of foreign-based companies that had gone public through a reverse merger process, the SEC approved rules proposed by the three major U.S. listing markets toughening the standards that companies going public in this manner must meet to become listed on those exchanges.

The Commission also approved rules submitted by FINRA and U.S. exchanges that will limit investors' exposure to unusual volatility in individual securities and the broader U.S. stock market. One initiative establishes a "limit up-limit down" mechanism that prevents trades in individual exchange-listed stocks from occurring outside of a specified price band. The second initiative updates existing market-wide circuit breakers that, when triggered, halt trading in all exchange-listed securities throughout the U.S. markets.

Finally, I am also pleased to report that for the ninth consecutive year, the SEC's independent auditors, the U.S. Government Accountability Office, has affirmed that the agency's financial statements earned an unqualified audit opinion and are presented fairly in all material respects, in conformity with the U.S. generally accepted accounting principles. The auditors also did not identify any material weaknesses in our internal controls or instances of material non-compliance with laws and regulations. Based on our review, we can confirm that the financial and performance data presented in this report are fundamentally complete, reliable, and conform to Office of Management and Budget guidance.

An aggressive approach to traditional investor protection through enforcement and examination efforts and the rulemaking process; an embrace of new responsibilities and tools contained in the Wall Street reform legislation; and an ongoing effort to streamline and enhance agency functions – all these are combining together to transform the SEC into the dynamic agency investors deserve and markets demand. At the SEC, we view our recent successes not as the end of a reform process but as the platform on which to continuously improve our ability to fulfill our mission. The SEC's nearly 4,000 employees are committed to that mission and carrying it out more effectively than ever.

Thank you.

Mary L. Schapiro
Chairman
November 15, 2012

Management's Discussion and Analysis

The U.S. Securities and Exchange Commission's (SEC) Management's Discussion and Analysis (MD&A) serves as a brief overview of this entire report. It provides a concise description of the agency's performance measures, financial statements, systems and controls, compliance with laws and regulations, and actions taken or planned. It also provides an assessment of the SEC's programs and financial performance, and the efficiency and effectiveness of the SEC's operations.

Information presented in this section satisfies the requirements for reporting on internal controls in Office of Management and Budget Circular A-123, *Management's Responsibility for Internal Control*.

Vision, Mission, Values and Goals

Vision

The SEC strives to promote a market environment that is worthy of the public's trust and characterized by transparency and integrity.

Mission

The mission of the SEC is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.

Values

Integrity	Teamwork
Accountability	Fairness
Effectiveness	Commitment to Excellence

Strategic Goals and Outcomes

Goal 1: Foster and enforce compliance with the Federal securities laws

Outcome 1.1: The SEC fosters compliance with the Federal securities laws.

Outcome 1.2: The SEC promptly detects violations of the Federal securities laws.

Outcome 1.3: The SEC prosecutes violations of Federal securities laws and holds violators accountable.

Goal 2: Establish an effective regulatory environment

Outcome 2.1: The SEC establishes and maintains a regulatory environment that promotes high-quality disclosure, financial reporting, and governance, and that prevents abusive practices by registrants, financial intermediaries, and other market participants.

Outcome 2.2: The U.S. capital markets operate in a fair, efficient, transparent, and competitive manner, fostering capital formation and useful innovation.

Outcome 2.3: The SEC adopts and administers rules and regulations that enable market participants to understand clearly their obligations under the securities laws.

Goal 3: Facilitate access to the information investors need to make informed investment decisions

Outcome 3.1: Investors have access to high-quality disclosure materials that are useful to investment decision making.

Outcome 3.2: Agency rulemaking and investor education programs are informed by an understanding of the wide range of investor needs.

Goal 4: Enhance the Commission's performance through effective alignment and management of human, information, and financial capital

Outcome 4.1: The SEC maintains a work environment that attracts, engages, and retains a technically proficient and diverse workforce that can excel and meet the dynamic challenges of market oversight.

Outcome 4.2: The SEC retains a diverse team of world-class leaders who provide motivation and strategic direction to the SEC workforce.

Outcome 4.3: Information within and available to the SEC becomes a Commission-wide shared resource, appropriately protected, that enables a collaborative and knowledge-based working environment.

Outcome 4.4: Resource decisions and operations reflect sound financial and risk management principles.

History and Purpose

During the peak of the Depression, Congress passed the Securities Act of 1933. This law, along with the Securities Exchange Act of 1934 (Exchange Act), which created the SEC, was designed to restore investor confidence in our capital markets by providing investors and the markets with more reliable information and clear rules of honest dealing. The main purposes of these laws were to ensure that:

- Companies publicly offering securities for investment dollars must tell the public the truth about their businesses, the securities they are selling, and the risks involved in investing.
- People who sell and trade securities – brokers, dealers and exchanges – must treat investors fairly and honestly, putting investors' interests first.

The SEC is responsible for overseeing the nation's securities markets and certain primary participants, including broker-dealers, investment companies, investment advisers, clearing agencies, transfer agents, credit rating agencies, and securities exchanges, as well as organizations such as the Financial Industry Regulatory Authority (FINRA), Municipal Securities Rulemaking Board (MSRB), and Public Company Accounting Oversight Board (PCAOB). Under the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] (Dodd-Frank Act), the agency's jurisdiction was expanded to include certain participants in the derivatives markets, private fund advisers, and municipal advisers among other changes.

The SEC consists of five presidentially appointed Commissioners, with staggered five-year terms. One of them is designated by the President as Chairman of the Commission (see *Appendix A: Chairman and Commissioners*). President Franklin Delano Roosevelt appointed Joseph P. Kennedy to serve as the first Chairman of the SEC.

By law, no more than three of the Commissioners may belong to the same political party. The Commission convenes regularly at meetings that are open to the public and the news media unless the discussion pertains to confidential subjects, such as whether to begin an enforcement investigation.

Each year, the SEC brings hundreds of civil enforcement actions against individuals and companies for violation of securities laws. Examples of infractions include insider trading, accounting fraud, and providing false or misleading information about securities or the companies that issue them. One of the major sources of information that the SEC relies on to bring enforcement action is investors themselves – another reason that educated and careful investors are critical to the functioning of efficient markets. To help inform investors, the SEC offers the public a wealth of educational information on its website at *http://www.investor.gov*, as well as an online database of disclosure documents at *http://www.sec.gov/edgar/searchedgar/companysearch.html* that public companies and other market participants are required to file with the SEC.

[1] *Dodd-Frank Wall Street Reform and Consumer Protection Act http:www.sec.gov/about/laws/wallstreetreform-cpa.pdf*

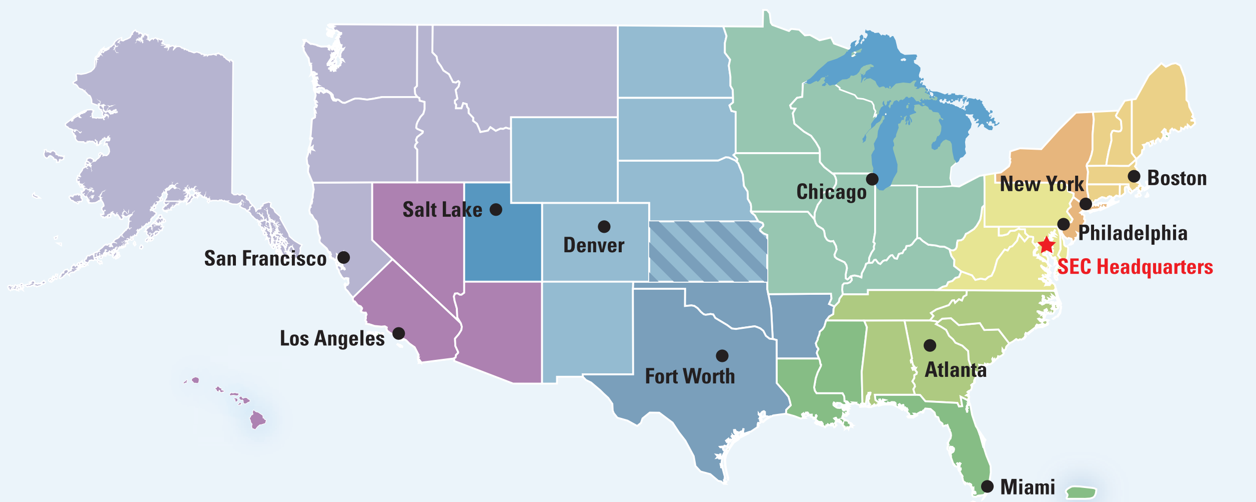
Organizational Structure and Resources

SEC Office Locations

The SEC's headquarters are in Washington, D.C., and the agency has 11 regional offices located throughout the country. The regional offices are responsible for investigating and litigating potential violations of the securities laws. The offices also have examination staff, who inspect regulated entities such as investment advisers, investment companies and broker-dealers. The map below shows the locations of the regional offices, and the states that are included in each region.

CHART 1.1

SEC HEADQUARTERS AND REGIONAL OFFICE LOCATIONS

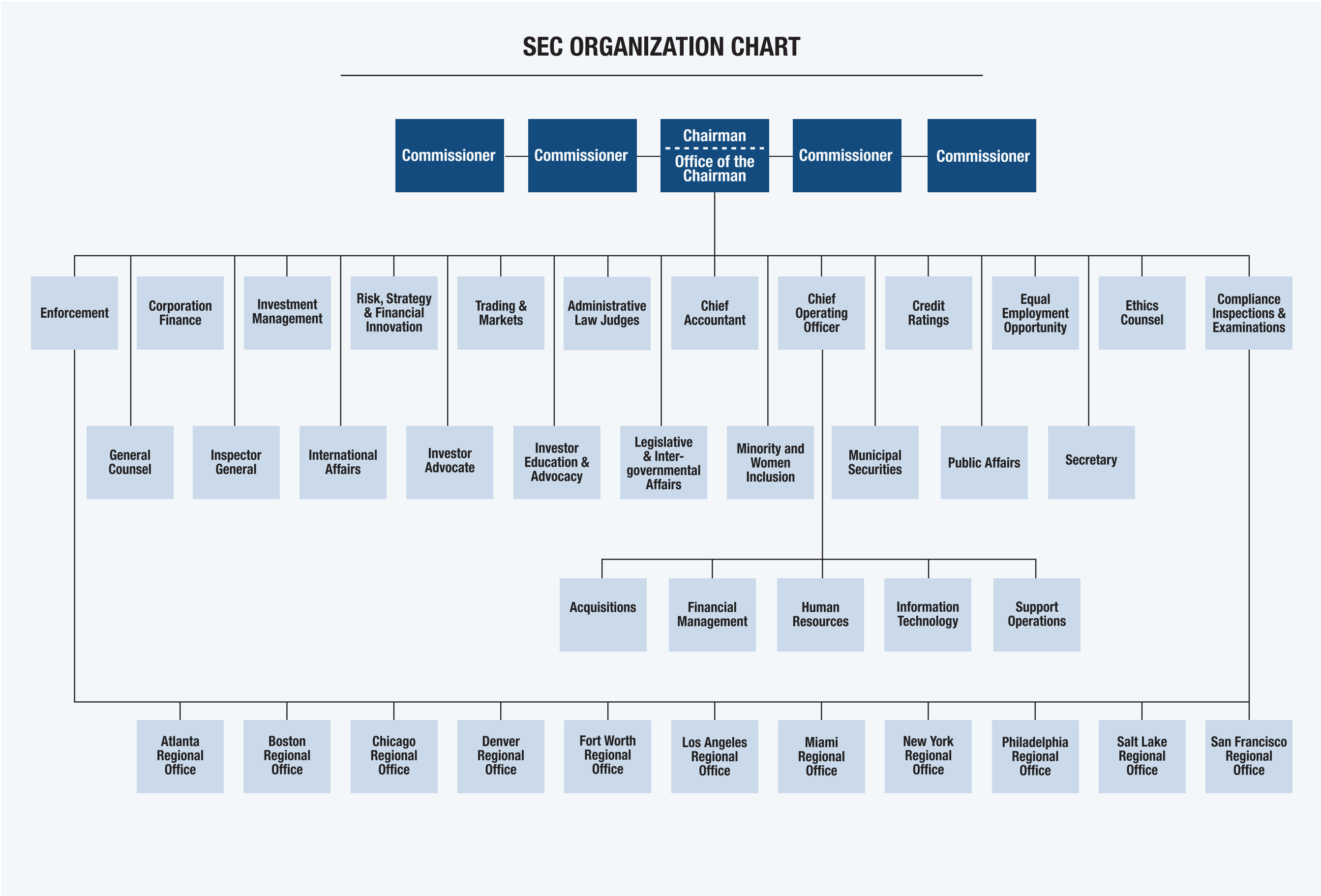


- **SEC Headquarters**
- **New York Regional Office**
  New York, New Jersey
- **Boston Regional Office**
  Connecticut, Maine, Massachusetts, New Hampshire, Vermont, Rhode Island
- **Philadelphia Regional Office**
  Delaware, Maryland, Pennsylvania, Virginia, West Virginia, District of Columbia
- **Miami Regional Office**
  Florida, Mississippi, Louisiana, U.S. Virgin Islands, Puerto Rico
- **Atlanta Regional Office**
  Georgia, North Carolina, South Carolina, Tennessee, Alabama
- **Chicago Regional Office**
  Illinois, Indiana, Iowa, Kentucky, Michigan, Minnesota, Missouri, Ohio, Wisconsin
- **Denver Regional Office**
  Colorado, Kansas, Nebraska, New Mexico, North Dakota, South Dakota, Wyoming
- **Fort Worth Regional Office**
  Texas, Oklahoma, Arkansas, Kansas (except for the exam program which is administered by the Denver Regional Office)
- **Salt Lake Regional Office**
  Utah
- **Los Angeles Regional Office**
  Arizona, Hawaii, Guam, Nevada, Southern California (zip codes 93599 and below, except for 93200-93299)
- **San Francisco Regional Office**
  Washington, Oregon, Alaska, Montana, Idaho, Northern California (zip codes 93600 and up, plus 93200-93299)

SEC Organization Structure

The SEC is an independent Federal agency established pursuant to the Exchange Act. It is headed by a bipartisan five-member Commission, comprised of the Chairman and four Commissioners, who are appointed by the President and confirmed by the Senate (see *Appendix A: Chairman and Commissioners*). The Chairman serves as the Chief Executive Officer. The SEC is organized into five main divisions: Enforcement; Corporation Finance; Investment Management; Risk, Strategy, and Financial Innovation; and Trading and Markets. In fiscal year (FY) 2012, the agency employed 3,785 full-time equivalents (FTE), including 3,754 permanent and 31 temporary FTEs. The SEC organization chart below is as of September 30, 2012.

CHART 1.2



SEC Programs

The SEC organizes its divisions and offices under the 10 major programs outlined below in *Table 1.1, SEC Programs and Program Descriptions*.

TABLE 1.1
SEC PROGRAMS AND PROGRAM DESCRIPTIONS

Program	Divisions and Offices	Program Descriptions
Enforcement	Division of Enforcement and enforcement staff within the SEC's regional offices	This program investigates and brings civil charges in Federal district court or in administrative proceedings based on violations of the Federal securities laws. An integral part of the program's function is to seek penalties and the disgorgement of ill-gotten gains in order to return funds to harmed investors. Also organized within the Enforcement program is the new Office of the Whistleblower, created under the Dodd-Frank Act to administer the SEC's Whistleblower Program that rewards individuals who provide the agency with tips that lead to successful enforcement actions.
Compliance Inspections and Examinations	Office of Compliance Inspections and Examinations and examinations staff within the SEC's regional offices	This program conducts the SEC's examinations of registrants such as investment advisers, investment companies, broker-dealers, self-regulatory organizations (SROs), credit rating agencies, transfer agents, and clearing agencies.
Corporation Finance	Division of Corporation Finance	This program performs functions to help investors gain access to materially complete and accurate information about securities, and to deter fraud and misrepresentation in the public offering, trading, voting, and tendering of securities.
Trading and Markets	Division of Trading and Markets	This program conducts activities to establish and maintain standards for fair, orderly and efficient markets, while fostering investor protection and confidence in the markets.
Investment Management	Division of Investment Management	This program seeks to minimize the financial risks to investors from fraud, mismanagement, self-dealing, and misleading or incomplete disclosure in the investment company and investment adviser segments of the financial services industry.
Risk, Strategy, and Financial Innovation	Division of Risk, Strategy, and Financial Innovation	The division provides economic analyses as part of Commission's rulemaking process; supports its rule review, examination and enforcement programs with data-driven, risk-based analytical methods; and oversees its Tips, Complaints and Referrals (TCR) and interactive data programs.
General Counsel	Office of the General Counsel	The Office of the General Counsel (OGC) serves as the chief legal officer of the Commission and provides independent legal analysis and advice to the Chairman, Commissioners, and operating divisions on all aspects of the Commission's activities. The General Counsel also defends the Commission in Federal district courts, represents the Commission in all appellate matters and *amicus curiae* filings, and oversees the SEC's bankruptcy program.

(Continued on next page)

TABLE 1.1 *Continued from previous page*

Program	Divisions and Offices	Program Descriptions
Other Program Offices	• Office of the Chief Accountant; • Office of Investor Education and Advocacy; • Office of International Affairs; • Office of Administrative Law Judges; • Office of the Investor Advocate • Office of Credit Ratings; and • Office of Municipal Securities	These offices are responsible for: • Serving as the chief advisor to the Commission on all accounting and auditing policy and overseeing private sector standards setting; • Serving investors who contact the SEC, ensuring that retail investors' perspectives inform the Commission's regulatory policies and disclosure program, and improving investors' financial literacy; • Administering the rules of the Commission with respect to the practices of municipal securities brokers and dealers, municipal advisors, and investors in municipal securities, and the practices of nationally recognized statistical rating organizations (NRSRO), including examinations of NRSROs; • Advancing international regulatory and enforcement cooperation, promoting converged high regulatory standards worldwide, and facilitating technical assistance programs in foreign countries; and • Adjudicating allegations of securities law violations.
Agency Direction and Administrative Support	• The Chairman and Commission; • Office of Legislative and Intergovernmental Affairs; • Office of Public Affairs; • Office of the Secretary; • Office of the Chief Operating Officer; • Office of Financial Management; • Office of Information Technology; • Office of Human Resources; • Office of Acquisitions; • Office of Support Operations; • Office of the Ethics Counsel; • Office of Minority and Women Inclusion; and • Office of Equal Employment Opportunity	The Chairman is responsible for overseeing all aspects of agency operations, and the Chairman and Commissioners are responsible for the review and approval of enforcement cases and formal orders of investigation and the development, consideration, and execution of policies and rules. The other offices in Agency Direction and Administrative Support are responsible for: • Working with Members of Congress on issues that affect the Commission; • Coordinating the SEC's communications with the media, the general public, and foreign visitors; • Reviewing all documents issued by the Commission, and preparing and maintaining records of Commission actions; • Maximizing the use of SEC resources by overseeing the strategic planning, information technology, financial management, records management, human resources, and administrative functions of the agency; • Ensuring that the SEC is an equal opportunity employer in full compliance with all Federal equal employment opportunity laws; and • Enhancing the diversity of the SEC's workforce, contractors, and regulated entities in accordance with existing Federal laws and regulations.
Inspector General	Office of Inspector General	The Office of Inspector General (OIG) is an independent office that conducts audits of programs and operations of the SEC and investigations into allegations of misconduct by staff or contractors. The mission of OIG is to detect fraud, waste, and abuse and to promote integrity, economy, efficiency, and effectiveness in the SEC's programs and operations.

As shown in the *Statement of Net Cost*, on page 65, the SEC presents its net costs of operations by the programs outlined above, consistent with the presentation used by the agency in submitting its budget requests.

FY 2012 Year in Review

An Ongoing Commitment to Improving Performance

The SEC's success in pursuing its investor protection and market stability missions in FY 2012 is a testament to the breadth and effectiveness of a reform effort that began three years before.

Aggressive enforcement and proactive oversight; institutional expertise acquired through hiring, in-house training and the creation of specialized units; a new collaborative approach that creates powerful institutional synergies; and upgraded technology and enhanced management strategies – all these have combined to yield one of the most far-reaching and effective operations in the SEC's history.

The results of this comprehensive effort are visible across the agency.

- A Division of Enforcement that continues to bring cases in near-record numbers, leading the effort against those who contributed to the financial crisis while expanding its reach into important new areas or the financial markets;
- An Office of Compliance Inspections and Examinations (OCIE) that detects fraud and other irregularities more effectively than ever and supports registrants' compliance efforts to protect investors interests proactively;
- A Division of Corporation Finance working more closely with key registrants, elevating the quality of filings to which investors have access and ensuring that high-profile IPOs are supported with accurate, informative disclosures; and
- A Division of Investment Management (IM) working with other financial agencies to reduce key systemic risks and the odds of another financial crisis.

The same attitude infuses the SEC's rulemaking. The Division of Trading and Markets (TM), working together with the Commodity Futures Trading Commission, is laying the groundwork for a more stable, transparent and efficient derivatives market. A new consolidated audit trail will allow the SEC to rapidly identify, track and reconstruct unusual or suspicious market behavior. And, important changes to trading regulations – including a revised "limit up-limit down" mechanism – will help protect investors, particularly retail investors, from dangerous and unusual volatility that can play havoc with their portfolios.

Technology upgrades are making SEC staff more efficient, improving back-office functions, and allowing attorneys and accountants to spend more time on their core functions and less on routine or administrative matters and back-office functions. Reorganized offices and divisions are deploying staff more effectively, and significant improvements to internal controls are helping the SEC become a better-managed agency.

These efficiencies and new strategies are vital to the SEC's ability to perform effectively at the level investors and our markets deserve. They allow the extraordinary men and women who staff the SEC to keep their commitment to the American people and take on ever-greater challenges.

The SEC has embraced technology and management upgrades that make it stronger and more effective and ensures that investors have the advocate they need in a financial system that offers more complexity, opportunity and risk than ever before.

Enforcement: Sustained High-Level Performance

Two years after the most significant reorganization in the Division's history, Enforcement continues to perform at a remarkably high level, achieving excellent results in an increasingly complex and global securities market. The Division's sustained high-level performance in FY 2012 – coming just one year after its record performance in 2011 – was aided by innovations, such as: a high-priority focus on cultivating in-depth expertise in financial markets, products and transactions, including enhanced training, increased hiring of industry and other experts, and the creation of specialized enforcement units focused on high-priority misconduct; a flatter management structure; streamlined and centralized processes and the improved utilization of information technology; and a vastly enhanced ability to collect, process and analyze tips, complaints and referrals, among other improvements. More than anything else, the Division's success reflects the creativity and doggedness that the Division staff brings to the day-to-day work of conducting investigations and building strong enforcement cases against wrongdoers.

The Division's actions in 2012 spanned the full spectrum of its enforcement program and were marked by aggressive and continued pursuit of institutions and individuals whose actions contributed to the financial crisis, a focus on exchanges and market structure issues aimed at ensuring a fair securities marketplace, innovative actions against hedge funds and investment advisers for a range of misconduct, continued efforts to combat insider trading by those who abused positions of trust and confidence, and prompt actions to halt offering frauds and Ponzi schemes that threaten and target vulnerable individuals. The Division's performance reflects its enhanced understanding of complex securities products and market practices and its willingness to pursue securities laws violations despite the challenges of litigating such complex actions against well-funded, sophisticated defendants.

The Division also is maximizing the reach and deterrent impact of its actions by utilizing risk-based, proactive measures to identify threats at an early stage so that actions to halt the misconduct can be brought quickly and investor harm minimized. Such measures include analysis of market and other data in an attempt to identify unusual conduct, such as too-good-to-be-true investment returns or signs of possible market manipulation. In 2012, such measures resulted in enforcement actions in areas such as aberrational performance reporting by hedge funds, compliance shortcomings by investments advisers, microcap fraud, and organized insider trading. Many similar, risk-based approaches are being utilized to investigate critical areas such as valuation, conflicts of interest, private funds, high frequency trading, and municipal securities.

In addition, the Division is upgrading its information technology resources to allow it to perform numerous functions more effectively and efficiently, including: managing the tips it receives from the public; processing the enormous volume of electronic evidence it receives; developing data analytics and data mining capabilities to support its investigations; and applying knowledge management and document management tools to certain mission critical functions. Combined with the consolidation of non-core tasks into a dedicated business management unit, these efforts further enhance the Division staff's ability to prosecute securities laws violations and protect investors.

The SEC brought 734 enforcement actions in FY 2012, the second highest number ever filed in a fiscal year (and one less than the 735 filed the prior year). Of these actions, 150 were filed in investigations designated as National Priority Cases, representing the Division's most important and complex matters – an approximately 30 percent increase over 2011. In addition, the Division obtained orders for $3.1 billion in penalties and disgorgement; continued to utilize the enhanced remedies available under the Dodd-Frank Act to bar numerous individual wrongdoers from working in the securities industry, and obtained other forms of relief that send a strong deterrent message and protect investors, including asset freezes, trading suspensions, and penny stock bars. Finally, the SEC made its first whistleblower payout to an individual who provided high-quality, significant information that helped stop a multi-million dollar fraud. Enforcement is receiving many excellent tips through the Whistleblower Program, resulting in significant savings in investigative resources and time.

A full description of the Division of Enforcement's actions filed in FY 2012 can be found in *Appendix B: Major Enforcement Cases*, but below is a brief summary that provides a selection of some of those matters.

Financial Crisis

Since the financial crisis, the SEC has filed 80 financial crisis actions against 117 individuals and entities, including 57 CEOs, CFOs, and other senior corporate officers. These enforcement actions have resulted in 36 individuals being barred from serving in the securities industry or as officers or directors at public companies as well as orders of more than $2.2 billion in disgorgement, penalties, and other financial relief, most of which has been or will be distributed to harmed investors. Twenty-nine of these actions were filed in 2012, up from the 23 filed in 2011.

- Among the most significant of these actions were the cases against the six former top executives of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) for misleading statements regarding the extent of each company's holdings of higher-risk mortgage loans, including subprime loans. The SEC's complaint against the former Fannie Mae executives alleges that, when Fannie Mae began reporting its exposure to subprime loans in 2007, it broadly described the loans as those "made to borrowers with weaker credit histories," and then reported — with the knowledge, support, and approval of its senior management — less than one-tenth of its loans that met that description. Similarly, the complaint against the former Freddie Mac executives alleges that they led investors to believe that the firm, using a broad definition of "subprime" loans, was disclosing all of its subprime loan exposure. Unbeknownst to investors, however, Freddie Mac had far more subprime exposure than it had disclosed in its SEC filings. Litigation in both of these matters is ongoing.

- Four former investment bankers and traders at Credit Suisse Group were charged for a complex scheme to fraudulently overstate the prices of $3 billion in subprime bonds during the height of the financial crisis. These individuals deliberately ignored specific market information showing a sharp decline in the price of the subprime bonds and, instead, marked them in a way that allowed Credit Suisse to achieve fictional profits. The mispricing scheme was motivated in part by the bankers' desire for lavish year-end bonuses and promotional opportunities within Credit Suisse.

- The SEC filed several actions charging bank and mortgage executives for misleading investors about mounting loan losses and the deteriorating financial condition at their institutions during the height of the financial crisis. In October 2011, the SEC charged four former executives of California-based United Commercial Bank with misleading investors about the size of the bank's loan losses in 2008 and 2009. In a similar action, the SEC charged three former executives of Lincoln, Nebraska-based TierOne Bank for participating in a scheme to understate millions of dollars in losses and mislead investors and Federal regulators at the height of the financial crisis. In March, the SEC charged the three senior-most executives at Thornburg Mortgage Inc., formerly one of the nation's largest mortgage companies, with hiding the company's deteriorating financial condition at the onset of the financial crisis. And in April, the SEC charged the former CEO and CFO of Franklin Bank Corp. for a fraudulent scheme designed to conceal the deterioration of the bank's loan portfolio and inflate its reported earnings during the last two quarters of 2007. The SEC's actions in these matters are continuing.

- In a significant action related to mutual funds, the SEC charged investment management company OppenheimerFunds Inc. and its sales and distribution arm with making misleading statements about two of its mutual funds that sustained large losses during the financial crisis. The SEC's order found that the two Oppenheimer funds used derivative instruments to add substantial exposure to commercial mortgages, which created large amounts of leverage in the funds. Steep declines in the commercial mortgage market drove down the net asset values of both funds, forcing Oppenheimer to raise cash to service the leverage generated by the derivative instruments by selling securities into an increasingly illiquid market. Oppenheimer disseminated misleading statements to investors about the funds' losses and their recovery prospects. Oppenheimer agreed to settle the SEC's charges by paying more than $35 million, which will be distributed to harmed fund investors.

- The SEC continued to charge misconduct related to collateralized debt obligations (CDOs) and other complex structured products in 2012. In July, the SEC charged the U.S. investment banking subsidiary of Japan-based Mizuho Financial Group and three former employees with misleading investors in a CDO by using "dummy assets" to inflate the deal's credit ratings. Mizuho structured and marketed Delphinus CDO 2007-1, a CDO that was backed by subprime bonds at a time when the housing market was showing signs of severe distress. The deal was contingent upon Mizuho obtaining credit ratings it used to market the notes to investors. When its employees realized that Delphinus could not meet one rating agency's newly announced criteria intended to protect CDO investors from the uncertainty of ratings downgrades, they submitted to the rating firm a portfolio containing millions of dollars in dummy assets that inaccurately reflected the collateral held by Delphinus. Mizuho agreed to pay $127.5 million to settle the SEC's charges.

Exchanges and Market Structure

The Division of Enforcement brought several actions involving compliance failures and rules violations relating to stock exchanges, alternative trading systems, and other market participants. These actions are critical to ensuring fair trading and equal access to information in our securities markets.

- In October 2011, the SEC sanctioned two electronic stock exchanges and a broker-dealer owned by Direct Edge Holdings LLC for violations arising out of two incidents that exposed the firms' weak controls and resulted in millions of dollars in trading losses and a systems outage. In one incident, untested computer code changes resulted in two electronic stock exchanges affiliated with Direct Edge over-filling orders submitted by three members, resulting in unwanted trades involving an estimated 27 million shares in about 1,000 stocks, totaling $773 million. To resolve the overfilled trades, the exchanges assumed and traded out of the overfilled shares in violation of their own rules and the Commission's rules on short selling. In the second incident, one of the electronic exchange's database administrators inadvertently disabled database connections, disrupting the exchange's ability to process incoming orders, modifications, and cancellations. Notwithstanding internal alerts and external notifications from members that something was wrong, the exchange waited approximately 24 minutes after the outage to remove its quotations from public market data, and violated the SEC's Regulation NMS by failing to immediately identify its quotations as manual quotations. The SEC censured Direct Edge and its affiliated exchanges for these violations and required them to undertake significant remedial measures.

- In its first-ever action against a "dark pool" trading platform, the SEC charged Pipeline Trading Systems LLC and two of its top executives with failing to disclose to customers of Pipeline's trading platform that the vast majority of orders were filled by a trading operation affiliated with Pipeline. Pipeline was registered with the SEC as an alternative trading system, a privately operated platform to trade securities outside of traditional exchanges. Alternative trading systems that display little or no information about customer orders are known as "dark pools." Investors use these venues to hide their trading intentions from others and avoid moving the market with large orders to buy or sell stock. Pipeline described its trading platform as a "crossing network" that matched customer orders with those from other customers, providing "natural liquidity." Pipeline's claims were false and misleading because its parent company owned a trading entity that filled the vast majority of customer orders on Pipeline's system. Pipeline violated the Federal securities laws by failing to disclose the affiliate's activities to Pipeline's investors. Pipeline settled with the SEC by paying a $1 million penalty and the two executives settled by paying penalties of $100,000 each.

- In September 2012, the SEC brought first-of-its-kind charges against the New York Stock Exchange for compliance failures that gave certain customers an improper head start on trading information. According to the SEC's order against NYSE, the exchange violated Regulation NMS over an extended period of time beginning in 2008 by sending market data through two of its proprietary feeds before sending that data to the consolidated public feeds. NYSE and its parent company, NYSE Euronext, agreed to a $5 million penalty and significant undertakings to settle the SEC's charges, marking the first-ever SEC financial penalty against an exchange.

Mutual Funds and Investment Advisers

With over 11,000 registered investment advisers managing more than $40 trillion in assets, investment advisers and the funds they manage continued to be a key focus of the Division. The SEC filed 147 investment adviser-related cases in FY 2012, one more than with the previous year's record performance. Among the more significant actions:

- The SEC charged Morgan Stanley Investment Management (MSIM) with violating the securities laws in a fee arrangement that repeatedly charged a fund and its investors for advisory services from a third party that they were not actually receiving. The SEC's investigation found that MSIM represented to investors and the fund's board of directors that it contracted a sub-adviser to provide advice, research and assistance to MSIM for the benefit of the fund. The sub-adviser did not provide these purported advisory services, yet the fund's board annually renewed the contract based on MSIM's representations for more than a decade at a total cost of $1.845 million to investors. MSIM agreed to pay more than $3.3 million to settle the SEC's charges.
- The SEC charged three investment advisers for failing to have compliance procedures designed to prevent securities law violations. The actions resulted from the Division's Asset Management Unit's initiative to identify registered investment advisers who lack effective compliance programs. The compliance failures identified at these firms included failing to adopt and implement written compliance policies, failing to implement written policies and procedures after SEC examiners had informed the firm of its deficiencies, failing to have a compliance chief who worked onsite and performed substantive responsibilities, and engaging in hundreds of principal transactions with advisory clients without informing them or obtaining their consent as required by law. All of the firms settled with the SEC by, among other things, paying penalties, returning certain funds to advisory clients, and agreeing to undertakings requiring them to review and improve their compliance operations.
- The SEC filed several enforcement actions charging three advisory firms and six individuals as part of an initiative to combat investment adviser fraud by identifying abnormal investment performance at hedge funds. The misconduct involved improper use of fund assets, fraudulent valuations, misrepresentations about the size and credentials of the investment firm's management team, and misrepresenting fund returns.

Insider Trading

The Commission continued its aggressive pursuit of those individuals who unlawfully traded on material, non-public information, undermining the level playing field that is fundamental to the integrity and fair functioning of the capital markets. In FY 2012, the Commission brought 58 insider trading actions. Many of these cases involved financial professionals, hedge fund managers, and corporate insiders who breached duties of trust and confidence for private gain.

- The SEC charged former McKinsey & Co. global head Rajat Gupta with insider trading for illegally tipping convicted hedge fund manager Raj Rajaratnam while serving on the boards of Goldman Sachs and Procter & Gamble. The SEC alleged that Gupta tipped Rajaratnam with information about the quarterly earnings of both Goldman Sachs and Procter & Gamble as well as an impending $5 billion investment in Goldman by Berkshire Hathaway at the height of the financial crisis. Rajaratnam traded on this information, generating more than $23 million in illicit profits or losses avoided. Gupta was convicted for this conduct in a criminal trial and sentenced to two years in prison.
- The SEC charged John Kinnucan and his Portland, Oregon-based expert consulting firm, Broadband Research Corporation, with insider trading. The SEC alleged that Kinnucan and Broadband claimed to be in the business of providing clients with legitimate research about publicly traded technology companies, but instead typically tipped clients with material, nonpublic information that Kinnucan obtained from prohibited sources inside the companies. Clients then traded on the information. Portfolio managers and analysts at prominent hedge funds and investment advisers paid Kinnucan and Broadband significant consulting fees

for the information they provided. Kinnucan in turn compensated his sources with cash, meals, ski trips, and other vacations. This matter arose out of the SEC's expert networks investigation, which has resulted in charges against 25 defendants and uncovered alleged illegal trading in the securities of more than a dozen companies, totaling nearly $120 million in illicit gains.

- The SEC took emergency action to freeze the assets of traders using accounts in Hong Kong and Singapore to hold more than $13 million in illegal profits by trading in advance of a public announcement that China-based CNOOC Ltd. was acquiring Canada-based Nexen Inc. The SEC's complaint alleged that Hong Kong-based firm Well Advantage Limited and other unknown traders stockpiled shares of Nexen stock based on confidential information about the deal in the days leading up to the announcement. The SEC took the emergency action within days of the public announcement of the deal and less than 24 hours after Well Advantage placed an order to liquidate its entire position of Nexen. Well Advantage agreed to settle the SEC's charges by paying more than $14 million, which is double the amount of its alleged illicit profits.

Market Manipulation

The Commission took significant action to combat fraud involving microcap securities. One of the most significant efforts was the mass trading suspension in which the Commission suspended the trading of 379 dormant companies before they could be hijacked and used to harm investors through reverse mergers and pump-and-dump schemes. The trading suspension, the largest in the agency's history, arose from an initiative of the SEC's Microcap Fraud Working Group, which utilized various agency resources, including the enhanced intelligence technology of the Enforcement Division's Office of Market Intelligence, to examine microcap stocks and identify dormant shell companies that were ripe for potential fraud.

Fraudulent Schemes

The Commission continued its efforts to bring enforcement actions against individuals and entities that prey on individuals and vulnerable populations with get-rich-quick schemes and promises of fantastic investment returns. Curtailing Ponzi schemes and other offering frauds and holding those responsible for these scams accountable is a vital component of the SEC's enforcement program.

- The SEC took emergency action to halt a real estate-based Ponzi scheme that defrauded more than 600 investors nationwide of a total of $100 million. The SEC's action charged Wayne L. Palmer and his firm, National Note of Utah, LC, with fraud in a scheme in which he raised money from investors by promising to use the proceeds to buy mortgage notes and other real estate assets. Palmer told investors that their money would be completely secure and that National Note had a perfect record, having never missed paying principal or interest on its promissory notes. Contrary to Palmer's claims, National Note used most of the money it took in from new investors to pay earlier investors, making it a classic Ponzi scheme.
- The SEC charged Ephren W. Taylor, a self-described "social capitalist" with running a Ponzi scheme that targeted socially conservative investors in church congregations. The SEC alleged that Taylor made numerous false statements to lure investors into two investment programs being offered through City Capital Corporation, where he was the CEO. Instead of investor funds going to charitable causes and economically disadvantaged businesses as promised, Taylor secretly diverted funds for his personal use, including promoting his books, hiring consultants to refine his public image, and funding his wife's singing career.

Municipal Securities

The Commission continued to focus on the critical municipal securities market in FY 2012. Areas of focus this year included conflicts of interest, pay-to-play schemes, and collusion by individuals and firms involved in state and local bond underwriting and other aspects of municipal financing.

- The SEC charged former Detroit mayor Kwame M. Kilpatrick, former city treasurer Jeffrey W. Beasley, and MayfieldGentry Realty Advisors LLC, the investment adviser to Detroit's public pension funds, for a pay-to-play scheme involving lavish gifts provided in exchange for influence over the funds' investment process. The SEC alleged that Kilpatrick and Beasley, who were trustees to the pension funds, received private jet travel and other perks from MayfieldGentry at a time when the firm was recommending to the trustees that the pension funds invest approximately $117 million in a real estate investment trust controlled by MayfieldGentry. Neither Kilpatrick and Beasley nor MayfieldGentry informed the board of trustees about the perks and the conflicts of interest they presented. The pension funds ultimately voted to approve the investment, and MayfieldGentry received millions of dollars in management fees.

- The SEC charged Goldman Sachs and one of its former investment bankers, Neil Morrison, with violations of various Municipal Securities Rulemaking Board (MSRB) rules for undisclosed "in-kind" non-cash campaign contributions to then-Massachusetts state treasurer Timothy P. Cahill while Cahill was a candidate for governor. Morrison, who was a vice president in Goldman's Boston office, conducted campaign activities from his office and used Goldman's resources, such as phones and email, on behalf of Cahill's campaign. Morrison's use of Goldman's resources for campaign activities constituted valuable in-kind contributions that were attributable to Goldman and disqualified the firm from engaging in municipal underwriting business with certain Massachusetts municipal issuers for two years after the contributions. Nevertheless, Goldman subsequently participated in 30 prohibited underwritings, earning more than $7.5 million in underwriting fees. Goldman settled the SEC's charges by agreeing to disgorge its underwriting fees and pay a $3.75 million penalty, the largest ever imposed by the SEC for MSRB pay-to-play violations.

A More Focused and Sophisticated Examinations Program

Launched in 2010, OCIE's National Exam Program (NEP) has a fourfold mission: to improve industry compliance, identify and prevent fraud, monitor risk, and inform policy.

In 2012, a strong combination of aggressive outreach to registrants' boards and senior management, sophisticated technology, close collaboration with other offices and divisions and the hard work of a committed staff allowed the NEP to lift its pursuit of this mission to new levels of performance.

Improving Compliance

The NEP recognizes that the compliance and risk management functions at many registrants are important resources that can aid its mission, and has launched an aggressive program of outreach to leverage and support these efforts.

This includes the NEP's public sweep report on broker-dealer information barriers and the five risk alerts issued in FY 2012; local and national industry outreach conferences; and engaging senior management and the boards of larger registrants in the examination process.

By providing accurate and timely information and actively reaching out to individuals who make key decisions, these actions lift the profile and enhance the effectiveness of compliance efforts within registrants' enterprise risk management systems.

Preventing Fraud

The NEP's risk-based targeting strategy has helped it focus its limited resources on entities most likely to present risk to investors, resulting in a significant rise in the percentage of examinations that result in findings deemed "significant" or referred to the Division of Enforcement for further action.

Much of this success is the result of close collaboration with other units within the agency. The NEP has created several specialized working groups to build expertise in areas that parallel the specialized units in the Division of Enforcement. A key function of these working groups is to provide an ongoing resource to examiners and managers when specialized topics are encountered.

NEP staff worked closely with the Divisions of Risk, Strategy and Financial Innovation (RSFI) and Enforcement, helping RSFI staff develop the Aberrational Performance Model — an analytical model that uses performance data to identify hedge fund advisers worthy of further review by either OCIE or the Enforcement's Asset Management Unit. This initiative has been extraordinarily successful, resulting in four Enforcement cases in 2012 and providing useful insights during the examinations themselves.

A number of examinations resulted in fraud cases, including four with roots in the financial crisis. These include:

- **Summit Wealth Management.** The SEC charged a private fund manager and his investment advisory firm with defrauding investors in a purported "fund of funds" and then trying to hide trading loses by creating new private funds to make money to pay back the original fund investors. Investor losses are estimated at $17 million among approximately 200 clients.
- **In re Wells Fargo Brokerage Services, LLC.** The SEC charged Wells Fargo's brokerage firms and a former official with selling investments tied to mortgage-backed securities to investors, such as municipalities and non-profit institutions, without fully disclosing their complexity or the risks involved. The SEC's order found that Wells Fargo also did not obtain sufficient information about the asset-backed commercial paper and CDOs that it sold, and relied almost exclusively on their credit ratings. Wells Fargo agreed to pay more than $6.5 million into a Fair Fund for the benefit of harmed investors.
- **In re Martin Currie Inc.** The SEC charged this Scotland-based fund management group with fraudulently using one of its U.S. fund clients to rescue another client, a hedge fund struggling in the midst of the global financial crisis. Martin Currie agreed to pay a total of nearly $14 million to the SEC and the United Kingdom's Financial Services Authority to settle the charges.

Monitoring Risk

The NEP has improved its ability to assess and surveil risk, allowing the program to better allocate and leverage limited resources on investors' behalf.

The new Office of Large Firm Monitoring has dedicated staff to the on-going monitoring of select large firms, particularly around financial risk. The Office of Risk Analysis and Surveillance (RAS) devotes significant resources guiding risk-focused exam strategy across each of the NEP's program areas: broker-dealers, investment advisers, investment companies, clearance and settlement agents, and market oversight. RAS works closely with the regions to focus examinations on registrants and practices that pose the greatest risk to market integrity and investor protection.

As part of its focus on larger firms, the NEP has completed risk profiles of each of the 21 national securities exchanges and Self-Regulatory Organizations (SROs), continues to perform risk monitoring of certain clearing agencies, and is moving to develop risk profiles of the largest and most systemically significant broker-dealers and fund complexes. A new Quantitative Analytics Unit will support and serve exams in the Investment Adviser/Investment Company (IA/IC) program nationwide.

Ongoing collaboration between the RSFI and RAS supports the quantitative system architecture and software tool projects designed to improve the collection and analysis of data from registrants and other sources for IA/IC exams and investigations.

Other risk focused efforts include:

- Enhanced focus on high-risk activities at firms, including: the valuation of investments that are privately placed, thinly-traded, or otherwise difficult to value (such as securities lending collateral investments); remuneration arrangements, especially when client monies are paid to entities affiliated with the adviser; and verification of the existence of client assets.
- Examinations of some of the most sophisticated algorithmic trading firms using new analytic capabilities.

OCIE's collaboration with other SEC units extends beyond the effort to detect and investigate fraud and into the effort to identify and limit risky practices. OCIE often coordinates with TM, beginning at the pre-exam stage, to set the scope of the examination and identify areas of focus. OCIE has also provided TM with post-examination briefings that have caused TM to ask firms to change certain practices. For firms requiring additional attention, OCIE teams up with TM to conduct not only requested exams but also additional on-site monitoring of targeted issues.

The NEP also works with IM to coordinate reviews of money market fund filings, and collaborates during reviews of these funds. In addition, OCIE utilizes data produced by IM's Office of Financial Analysis when assessing the investment companies' risk, while IM frequently consults with OCIE regarding examination trends, findings and industry observations.

Informing Policy

As the SEC's eyes and ears in the field, OCIE adds valuable perspective to the policy and rulemaking processes.

An important purpose of many examinations is to help the Commission and its staff understand whether existing rules are working as intended, and to inform possible rulemaking.

The NEP has given substantial input into Commission rulemaking throughout the Dodd-Frank process, participating in over 50 working groups to interface with the policy divisions on rulemaking that includes: Title VII rules regarding dealer payment, clearing and settlement supervision; development of Form PF and revisions to Form ADV; registration of municipal advisers and Nationally Recognized Statistical Rating Organizations; and the "Volcker Rule."

Ensuring Consistent, Accurate Accounting for Investors

The Office of the Chief Accountant (OCA) supported continued progress toward convergence of U.S. and international accounting standards in two chief ways. First, the OCA completed its Work Plan for the Consideration of Incorporating International Financial Reporting Standards (IFRS) into the Financial Reporting System for U.S. issuers. In November, OCA and the Division of Corporation Finance published a staff paper on the application of IFRS in practice, and OCA published a staff paper analyzing differences between U.S. GAAP and IFRS. In July, OCA published the staff's final report on the Work Plan.

Second, OCA continued to monitor and support the activities of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) as they made progress in their convergence projects, which include revenue recognition, leasing transactions, and financial instruments.

OCA also oversaw the work of the Public Company Accounting Oversight Board (PCAOB), including its standard-setting agenda and its inspections of registered public accounting firms. On an issue of significant importance to Americans considering investing in a corporation based overseas, OCA worked with the PCAOB and the SEC Office of International Affairs on continuing negotiations with certain jurisdictions, most notably the European Union and China, on obtaining access to conduct inspections.

OCA also worked with TM to oversee FINRA's development of a dedicated independent funding source for the Government Accounting Standards Board by means of a fee authorized in the Dodd-Frank Act.

Improving the Quality of Investor Information

In addition to significant rulemaking responsibilities under the Dodd-Frank Act and the Jumpstart Our Business Startups (JOBS) Act, the Division of Corporation Finance worked to protect investors by improving the quality of information disclosed to investors, with a particular focus on high-profile entities and complex products. The Division of Corporation Finance's Disclosure Operations functions enhanced investor protection through focused comments on offering documents for several significant initial public offerings (IPOs) in FY 2012, reviewing key elements of pre-IPO disclosures, focusing on issues including:

- Appropriate use of non-GAAP measures in the offering documents;
- Disclosure of dual-class structures that can give a company's founder significantly more voting power than other investors;
- Disclosure of non-financial key metrics, including how they are used by the company and any limitations associated with them;
- Disclosure relating to valuation of the company's stock; and
- Shareholder rights and the ability to bring actions to address issues relating to those rights in our courts.

The Division also continued to focus on disclosures by the nation's largest financial institutions, reviewing, on an almost real-time basis, their annual, quarterly and current reports. This process allows the staff to engage more frequently with company representatives through comment letters and telephone interactions, resulting in improved disclosures throughout the year.

The Division of Corporation Finance's Office of Capital Markets Trends initiated product-focused evaluations of prospectus supplements as part of its review of structured note offering documents. Structured notes are complex debt securities generally sold to retail investors in which payments are based on the performance of various asset classes such as a single security, baskets of securities, commodities, currencies or indices. The staff took steps to enhance investor understanding of these complex offerings, including issuing and posting on the SEC's Website a comment letter to the largest issuers of structured notes calling for improved disclosure in future offerings.

Pursuing a Robust, Investor-Focused Rulemaking Agenda

The SEC continued to pursue a robust, investor-focused rulemaking agenda – one of the most ambitious agendas in decades. Propelled in part by the demands of the Dodd-Frank Act and the recognition that investor protection regulation needs to reflect the reality of today's modern technology-driven global market structure, the Commission acted – and continues to act — aggressively on a number of fronts.

The Commission's rulemaking has been supported by detailed economic analysis provided by RSFI, which recently provided guidance to the rulemaking divisions and offices for use in connection with Commission rulemakings. The guidance, called "Current Guidance of Economic Analysis in SEC Rulemakings," provides a high-level approach to economic analysis, drawing on concepts from various sources, including guidance issued by the Office of Management and Budget, studies performed by the SEC Inspector General, as well as various court cases. It provides a road map for staff, listing concepts that the analysis should cover and helping ensure that economic analysis is integrated throughout the entire rule development and rule writing process.

Dodd-Frank Act

Systemic Risk

The Commission continued to work with other financial regulators to fashion rules that diminish the possibility of a systemic breakdown similar to what the markets experienced in 2007 and 2008.

The Commission completed steps to implement the Dodd-Frank Act's mandates with respect to advisers to hedge funds and other private funds. Specifically, during FY 2012, the Commission, with the Commodity Futures Trading Commission (CFTC), jointly adopted Form PF, which requires registered advisers to hedge funds and other private funds to provide information regarding the private funds they advise. The information, which is collected on a non-public basis, will assist the Financial Stability Oversight Council in its monitoring of systemic risk.

The largest hedge fund advisers, those with assets under management of over $5 billion in hedge funds, were required to first file Form PF in August 2012. Other private fund advisers, including smaller hedge fund advisers and advisers to private equity funds, will begin filing Form PF information in the first quarter of 2013. By close of FY 2012, more than 1,400 new advisers to major hedge funds and other private funds had registered with the agency.

In addition, the Commission, acting with banking regulators, jointly proposed a rule implementing section 619 of the Dodd-Frank Act — "The Volcker Rule" – which generally prohibits a banking entity from engaging in proprietary trading or owning, sponsoring, or having certain relationships with a hedge fund or private equity fund.

Derivatives

In 2008, opacity and other issues in the over-the-counter derivatives market compounded significantly the damage caused by the financial crisis. This year, the SEC continued to propose and adopt rules under Title VII of the Dodd-Frank Act – the title designed to improve transparency and facilitate the centralized clearing of swaps, helping, among other things, to reduce counterparty risk. It also is designed to enhance investor protection by increasing disclosure regarding swap transactions and helping to mitigate conflicts of interest involving swaps. By promoting transparency, efficiency, and stability, this framework is intended to foster a more nimble and competitive swap market and enhance regulatory oversight and monitoring of this market by facilitating improved access to comprehensive data on swap transactions.

Title VII directs the Commission – led by TM and working in concert with the CFTC – to write rules that build this framework, with the Commission principally responsible for the rules regarding security-based swaps. In implementing Title VII, the staff of the Commission is in regular contact with the staffs of the CFTC, Federal Reserve Board, and other financial regulators. In addition, TM is working with RSFI on rulemakings under Title VII. Among other efforts, RSFI has provided independent analysis related to credit default swap trading to inform rulemaking related to intermediary definitions, capital and margin requirements, and cross-border transactions, and clearing standards and processes.

The Commission also continued to consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards that minimize the opportunity for regulatory arbitrage and help to ensure that new regulations do not place U.S. markets at a disadvantage.

The agency's Office of International Affairs (OIA) and the Chairman initiated two multilateral meetings of leaders and senior representatives from key securities markets with responsibility for the regulation of the over-the-counter (OTC) derivatives markets. The meetings provided a forum for discussion among regulators responsible for introducing rules designed to implement new international standards relating to OTC derivatives.

In addition, representatives from the Commission meet frequently with representatives from the EU and other major foreign regulatory jurisdictions in Asia and North America. Representatives from the Commission also participate in the Financial Stability Board's Working Group on OTC Derivatives Regulation, of which a Commission representative serves as one of the co-chairs on behalf of the International Organization of Securities Commissions (IOSCO).

In FY 2012, the Commission adopted final rules and interpretations jointly with the CFTC regarding key product and entity definitions, which form the foundation for much of the remaining rulemaking.

The product definitions rulemaking further defines the terms "swap," "security-based swap," and "security-based swap agreement," and also contains rules regarding the regulation of "mixed swaps" and the books and records requirements for security-based swap agreements. These rules and interpretations will assist market participants in determining whether particular agreements, contracts, and transactions are subject to Title VII. In addition, they will assist market participants in determining whether a particular Title VII instrument is a swap subject to CFTC regulation, a security-based swap subject to Commission regulation, or a mixed swap subject to regulation by both the CFTC and the Commission.

The entity definitions rulemaking further defines the term "security-based swap dealer," among others, and adopts interpretations providing guidance as to how the dealer-trader distinction applies to activities involving security-based swaps. This guidance describes what constitutes dealing activity and distinguishes dealing from non-dealing activities such as hedging.

The Commission also adopted rules that establish procedures for its review of certain actions undertaken by clearing agencies, detailing how clearing agencies inform the Commission about the security-based swaps the clearing agencies plan to accept, and allowing the Commission to help determine whether those security-based swaps require clearing. The adopted rules also include rules requiring clearing agencies that are designated as "systemically important" under Title VIII of the Dodd-Frank Act to submit advance notice of changes to their rules, procedures, or operations if the changes could materially affect the nature or level of risk at those clearing agencies.

The Commission has requested comments on the order in which it expects to require compliance with the rules the Commission is adopting, with the goal of avoiding the cost and disruption that could result if compliance with all of the rules were required simultaneously or haphazardly.

Investor Advisory Committee

As required by Section 911 of the Dodd-Frank Act, the Commission established a new Investor Advisory Committee to advise it on regulatory priorities, the regulation of securities products, trading strategies, fee structures, the effectiveness of disclosure, and initiatives to protect investor interests and to promote investor confidence and the integrity of the securities marketplace. Members of the newly formed committee were nominated by all five sitting Commissioners and represent a wide variety of interests, including senior citizens and other individual investors, mutual funds, pension funds, and state securities regulators. The Dodd-Frank Act authorizes the committee to submit findings and recommendations for review and consideration by the Commission.

Performance Fees

The Commission adopted amendments under the Advisers Act, which restricts investment advisers from charging performance fees to investors unless they meet certain eligibility tests. The amendments exclude an investor's primary residence from the "net worth" test of the rule, in order to make the rule consistent with a similar change that was mandated by the Dodd-Frank Act to the "accredited investor" net worth test in the Securities Act; revise the dollar amount thresholds in eligibility tests in order to codify a July 2011 order issued by the Commission under the Dodd-Frank Act; provide the method for calculating future inflation adjustments of the dollar amount eligibility tests; and modify the transition provisions of the rule to take into account performance fee arrangements that were permissible at the time the adviser and client entered into their advisory contract.

Corporate Governance

The Commission adopted regulations directing the national securities exchanges and national securities associations to prohibit the listing of any equity security of an issuer that does not comply with new compensation committee and compensation adviser requirements. The regulations also revised the proxy disclosure rules concerning issuers' use of compensation consultants and related conflicts of interest.

Specialized Disclosures

The SEC adopted rules, required by Section 1502 of the Dodd-Frank Act, regarding so-called "conflict minerals." These rules require issuers whose products contain conflict minerals to disclose annually whether any of those minerals originated in the Democratic Republic of the Congo or an adjoining country. If an issuer's conflict minerals originated in those countries, they are required to submit a report to the Commission that includes a description of the measures it took to exercise due diligence on the conflict minerals' source and chain of custody.

Pursuant to Section 1503 of the Dodd-Frank Act, the Commission also adopted Mine Safety regulations which require mining companies to disclose information about specified mine safety and health matters in their quarterly and annual reports.

Further, the Commission adopted resource extraction regulations called for under Section 1504 of the Dodd-Frank Act, which require resource extraction issuers to file information relating to any payment made by the issuer, a subsidiary of the issuer, or an entity under the control of the issuer, to a foreign government or the Federal Government for the purpose of the commercial development of oil, natural gas, or minerals.

Identity Theft

The Commission, jointly with the CFTC, proposed rules that would require certain funds, broker-dealers, and investment advisers to adopt and administer programs to identify and respond to "red flag" indications of potential identity theft. The proposed rules were issued in response to the Dodd-Frank Act's mandate that transferred the responsibility for identity theft red flags rulemaking and enforcement from the Federal Trade Commission (FTC) to the SEC and CFTC for the entities regulated by the SEC and the CFTC.

Other Rulemaking Initiatives

Market Structure and Investor Protection

The Commission voted to require the national securities exchanges and the FINRA to establish a market-wide consolidated audit trail that will significantly enhance the SEC's ability to monitor and analyze trading activity. The new rule requires the exchanges and FINRA to jointly submit a comprehensive plan detailing how they would develop, implement, and maintain a consolidated audit trail that must collect and accurately identify every order, cancellation, modification, and trade execution for all exchange-listed equities and equity options across all U.S. markets.

The Commission also approved two proposals submitted by the national securities exchanges and FINRA that are designed to address extraordinary volatility in individual securities and the broader U.S. stock market.

One initiative establishes a "limit up-limit down" mechanism that prevents trades in individual exchange-listed stocks from occurring outside of a specified price band. When implemented, this new mechanism will replace the existing single-stock circuit breakers that the Commission approved on a pilot basis after the market events of May 6, 2010.

The second initiative updates existing market-wide circuit breakers that when triggered, halt trading in all exchange-listed securities throughout the U.S. markets. The existing market-wide circuit breakers were adopted in October 1988 and have been triggered only once, in 1997. The changes lower the percentage-decline threshold for triggering a market-wide halt.

In addition, the Commission approved new rules from the three major U.S. listing markets that toughen the standards that companies going public through a reverse merger must meet, in order to become listed on those exchanges. Reverse mergers permit private companies, including those located outside the U.S., to access U.S. investors and markets by merging with an existing public shell company. In some cases, regulators and auditors have had greater difficulty obtaining reliable information from reverse merger companies, particularly those based overseas.

Mutual Funds

The Commission re-opened the comment period on a 2010 rule proposal to improve disclosure of target date funds (TDF), after posting the results of an investor survey of use, comprehension and perception of TDFs. The proposal would require certain TDF advertising materials to include: a "tagline" showing the fund's asset allocation at the target date adjacent to the fund's name; a glide path illustration consisting of a table, chart, or graph showing the changing allocation over time, along with an accompanying explanation; and narrative risk disclosures. The rulemaking would also provide additional guidance regarding statements in marketing materials that could be misleading. The Commission is considering a total of 78 comment letters from 67 different commenters as the rulemaking moves towards adoption.

In FY 2012, IM staff devoted significant resources to issues presented in two concept releases issued by the Commission in 2011. The concept releases dealt with (1) the use of derivatives by investment companies and (2) the status under the Investment Company Act of certain mortgage-related pools. The staff continued to analyze comments received on the concept releases; assess the viability of various proposals and approaches suggested by the commenters; and identify any issues that may benefit from further public comment. In each case the goal was to determine whether to recommend to the Commission any modifications or additions to existing rules, regulations or guidance.

JOBS Act Rulemaking and Implementation

Led primarily by the Division of Corporation Finance, the SEC has worked to implement the JOBS Act quickly and pragmatically.

Under a process first utilized with the Dodd-Frank Act, the SEC created a Web address that allowed the public and interested parties to comment on JOBS Act rulemakings in advance of the legally required comment period, which begins when a rule or amendment is officially proposed.

The day the bill became law, staff posted procedures on the Commission's Website explaining how emerging growth companies could submit draft registration statements for confidential non-public review, as permitted by the JOBS Act. Staff continued to work to simplify that process, implementing an EDGAR-based system that will provide for the electronic transmission and receipt of confidential submissions.

Soon after, staff prepared and posted on the Commission's Website frequently asked questions that provide guidance to issuers and their advisers about matters related to the law's IPO "on-ramp" provisions, as well as changes to the requirements for Section 12(g) registration and deregistration. In addition, staff has been working on rulemaking recommendations for the Commission to implement those provisions of the JOBS Act that require rulemaking, including the proposed rules concerning general solicitation issued by the Commission in August 2012 to implement Title II of the JOBS Act.

Working Toward Regulatory Consistency in a Global Market

Commerce, finance and fraud now flow across national frontiers with unprecedented speed, adding urgency to the efforts of the SEC's OIA and its work to protect investors from cross-border fraud and to encourage international consistency in key areas of financial regulation.

Enforcement

OIA worked closely with the Division of Enforcement to obtain evidence abroad for SEC-filed actions related to foreign persons and entities who were alleged to have engaged in insider trading, the marketing of CDOs without full disclosure, market manipulation schemes, financial fraud and bribery and book and records violations under the Foreign Corrupt Practices Act. It traced, froze and repatriated more than $28 million of securities fraud proceeds located abroad.

OIA also worked extensively with foreign securities agencies, aiding investigations in Israel, France, Hong Kong and Malaysia by conducting the testimony of witnesses residing in the U.S.

OIA also advised the SEC trial section on how to serve defendants, secure depositions and other evidence, and handle complex international litigation in Australia, Germany, the United Kingdom, Canada, Hong Kong, Switzerland, China and other foreign jurisdictions. OIA submitted 718 requests for assistance to foreign authorities and, in turn, processed 450 such requests from foreign authorities. It also handled 149 tips, complaints and referrals from the Division of Enforcement and foreign regulators.

International Agreements

The SEC entered into Supervisory Memoranda of Understanding with three key overseas regulatory agencies, covering consultation, cooperation and the exchange of information related to cross-border regulated entities. These agreements with Brazil CVM (Securities Commission of Brazil), the Cayman Islands Monetary Authority and the European Securities and Markets Authority enhance SEC staff's ability to share information about such regulated entities as investment advisers, investment fund managers, broker-dealers, and credit rating agencies.

OIA worked closely with staff in other SEC Divisions and Offices, encouraging overseas efforts to align international policy positions and regulatory strategies with SEC regulatory approaches in forums including IOSCO and the Financial Stability Board. Areas of focus include reform of the over-the-counter derivatives market, exchange traded funds, investment companies, accounting standards, reducing reliance on credit rating agencies, and international cooperation and information sharing.

Using Resources More Effectively

The SEC is working to meet its growing menu of responsibilities with management and operations improvements that allow it to increase capacity while limiting costs, upgrade key systems, and operate in a more efficient and transparent manner.

Finance

The SEC completed its migration to a Federal Shared Service Provider (FSSP), adopting a new procurement system and financial system hosted by the Department of Transportation's Enterprise Services Center. The goal of this migration is to put the SEC's internal controls on a strong footing over the long term. As one example of gaining in functionality brought by the FSSP migration, the procurement system and financial system are joined by an automated interface, which is strengthening controls over obligations.

Over the past year, the agency also has improved management of contract closeout activity; eliminated long-standing, multi-million dollar backlogs in registrant deposit and filing fee administration; and virtually eliminated travel voucher processing backlogs for our employees.

Management

A new Performance Management system for senior officers better distinguishes between levels of contribution to the SEC's success, provides useful performance feedback, and identifies opportunities for executive development. We also have moved to a "pay for performance" approach for our non-bargaining unit employees.

Enhancements in practices, systems, training and overall process transparency in the Freedom of Information Act (FOIA),

Facilities, and Records Management Offices have yielded significant efficiencies and improved agency capabilities. In FY 2012, the SEC received 11,292 FOIA requests – the third consecutive year that the agency received more than 10,000 requests. And, at 370, the number of pending FOIA requests at the end of the fiscal year is the lowest it has been in 11 years. Improved FOIA practices have led to a 35 percent decrease in FOIA appeals.

Operations

The SEC is investing aggressively in its information technology (IT) systems, including continued improvements in the centralized Tips, Complaints and Referrals system, enforcement and examination management systems, risk analysis tools, and financial management systems.

The SEC has embarked on a multi-year Technology Transformation Plan called "Working Smarter," which will reduce costs by streamlining, integrating and upgrading the SEC's business processes. The resulting efficiencies will mean better services to both employees and the public and greater accountability, transparency, and security for the agency.

The Technology Transformation Plan supports vital technology initiatives.

- An enterprise data warehouse will provide a central area for the SEC to verify, cleanse, and merge disparate data, allowing advanced search and discovery capabilities and enterprise-wide knowledge management.
- New knowledge management strategies are eliminating work product redundancy by reusing, rather than reinventing, legal research, resulting in increased productivity and improved decision-making.
- A migration to a single high-performing data platform is allowing the SEC to consolidate to fewer, trusted data sources, defined by an enterprise data model, and to implement key data quality programs.
- Enhanced predictive analytical capabilities are allowing seamless searches of data sets to examine activity and reveal behavior that may indicate securities fraud, and rapid action to trace the origins and further investigate.
- These capabilities, and other growing data storage demands, are supported by a data storage capacity that, in FY12, grew five petabytes.
- The investing public is seeing results, as well. EDGAR has reduced filer burden by providing two paths, one for professionals and one for novice filers. Operational and maintenance costs are down by 45 percent, while the ability to meet SEC requirements in real time is increased.
- And, improvements to SEC.gov have helped drive average daily hits up almost 300 percent since the changes, from 14 million hits per day, to 39 million, as the public and investment community embrace the near real-time dissemination of information. Investors are staying 50 percent longer and viewing 18 percent more pages, but the demand on SEC bandwidth is down 31 percent.

Such IT improvements are bringing increased agility and measurable performance improvements, and significant cost savings, as well.

Improving Understanding of the Securties Markets

The SEC is uniquely positioned to monitor emerging trends and lingering challenges in the securities markets and to conduct thorough studies and analyses that lay the groundwork for what may become significant policy or regulatory activity or which change the way markets and regulations are analyzed and understood. In FY2012, the agency tackled both practical investor protection concerns and more academic examinations of the capital markets.

- The SEC issued a comprehensive report with recommendations for improving the structure of the $3.7 trillion municipal securities market and enhancing the disclosures provided to investors. Without a statutory regime for municipal securities regulation, the SEC's investor protection efforts in the municipal securities market have been limited. The SEC's report discusses potential legislative changes that could help improve disclosures to investors, including authorizing the SEC to set baseline disclosure standards and require municipal issuers to have audited financial statements.
- RSFI produced a White Paper entitled, "Capital Raising in the U.S.: the Significance of Unregistered Offerings Using the Regulation D Exemption," which considers whether the amount of public and private capital formation has changed over time. The study analyzes public and unregistered private debt and equity offerings. Data from unregistered private offerings are obtained from issuers that claim Regulation D, 144A, and Regulation S exemptions using Form D filings, which were recently required to be data-tagged.
- RSFI also released a report to Congress as part of the JOBS Act, which required the Commission to study the effects of decimalization on IPOs and small and middle capitalization companies.
- The Office of Investor Advocacy and Education completed a Dodd-Frank Act mandated study of financial literacy among investors, drawing on numerous sources, including online survey research, focus group research, public comments to the Commission, and a Library of Congress review of studies of financial literacy among U.S. retail investors. The study identified investor perceptions and preferences regarding information available to them and examined pre-investment disclosures; the fees, objectives, performance, strategy and risks of funds; and the professional background, disciplinary history, and conflicts of interest of a financial professional. The study found that investors favor investment disclosures presented in a visual format, using bullets, charts, and graphs.

Conclusion

An energized and increasingly-sophisticated SEC is meeting its growing responsibilities in the post-Dodd-Frank Act environment with new structures, more efficient management, upgraded technology and a more forward-looking approach to regulation and oversight. Confronted with a growing and increasingly complex marketplace, the SEC has responded with a determination to step up to new challenges and extend its ability to protect investors and stabilize markets into new areas and overlooked portions of the financial and regulatory landscape. Working with better tools, and encouraged to adopt an outlook as entrepreneurial as that of markets they regulate, the SEC staff has embraced this new era by responding more rapidly and effectively than ever to the needs of investors, from the most sophisticated institutional fund to the millions of retail investors trying to capture their dreams in the financial markets.

Looking Forward

2013: A Year of Continuing Progress

In 2013, the SEC will continue to embrace its ever-increasing regulatory and oversight responsibilities while further improving performance in the functions that have traditionally defined the agency in the eyes of the financial markets and American investors. These include aggressive enforcement actions, thorough examinations, proactive disclosure efforts, and robust rules focused on investor protection.

Much of this will be accomplished through better use of the Commission's most powerful tool, the nearly 4,000 talented and motivated men and women who work at the SEC. Among other advancements, staff will have better access to needed technology, as improvements continue to come on-line – improvements that include data mining, workflow, and risk analysis tools that allow the staff to keep up with an increasingly complex financial system. Investors will continue to benefit, as well, from a commitment to improving staff skills and to deploying personnel in ways that leverage in-house expertise and experience in key areas.

SEC staff will work towards completion of Dodd-Frank Act rulemaking, filling regulatory gaps that were highlighted by the financial crisis and that posed risks for both individual and institutional investors. Staff will also focus on further implementation of the JOBS Act, designed by Congress to give entrepreneurs greater access to early-stage capital.

Enforcement: Expanding Focus and Improving Results

The Division of Enforcement will continue to focus its efforts on bringing strong actions that punish securities law violators and deter future misconduct. The Division will also continue to upgrade its technology and increase staff expertise and specialization. This combination of technology and expertise allows the Division to identify hidden or emerging threats at an earlier stage and minimize investor harm by swiftly bringing action to halt misconduct. The Enforcement Division's priorities in 2013 include:

- Investigating vigorously and bringing enforcement actions in high priority areas, including misconduct related to the financial crisis, market structure, investment advisers and private funds, municipal securities, insider trading and complex financial products;
- Building on risk-based, proactive initiatives and other capabilities to identify threats to the markets at an earlier stage and act quickly to halt misconduct;
- Developing and enhancing staff expertise so that the Division can quickly grasp developments in increasingly complex securities markets and products, and properly identify new areas of potential risk to investors;
- Improving information technology resources to better manage the tips, complaints, and referrals received; process the tremendous amount of electronic evidence associated with SEC investigations; develop data analytics necessary to support proactive measures and the ability to investigate complex trading schemes; and apply knowledge management and document management tools to mission critical functions; and
- Refining performance metrics to improve case and resource allocation and prioritization, as well as the quality of information provided to the public.

A Multi-layered Examination Approach

With resources at a premium, OCIE will continue to embrace a broad array of techniques that allow it to focus its exam efforts on entities who present a higher risk to investors. At the same time, OCIE examiners will continue leveraging their resources by reaching out to senior management, boards of directors and individuals within the firms whose active involvement sets the tone for the firm's compliance practices and who can minimize the risk of a violation. In the coming year, OCIE's NEP will:

- Continue to focus on fraud. In its risk-based approach to targeting registrants and business practices, the NEP will utilize and enhance quantitative and qualitative tools and analyses that allow it to better identify market participants engaged in fraudulent or unethical behavior. The staff will also encourage tips, complaints, and referrals from investors, registrants and other parties to help it identify potential frauds.

- Continue to meet with independent board members, senior management, internal audit, key risk and control functions, and leaders of business lines to discuss enterprise risk, and in particular, how a firm governs and manages financial, legal, compliance, operational, and reputational risks. This initiative will help the NEP to: understand a firm's approach to enterprise risk management; evaluate a firm's tone at the top; and initiate a dialogue on key risks and regulatory requirements. It is also designed to better inform examinations of such firms.
- Focus on specific conflicts of interest, as well as risk governance frameworks that firms may have in place to identify and address conflicts. Conflicts of interest, when not eliminated or properly managed, are a leading indicator of significant regulatory issues for individuals, firms – particularly large and complex financial institutions – and, sometimes, the entire market.
- Focus on governance and supervision of firms' information technology systems in areas such as operational capability, business continuity planning, market access, and information security – including risks of system outages, data integrity compromises, and cyber intrusions. A number of recent market events have underscored the importance of remaining current with new trading technologies and their implications for the maintenance of transparent, fair and stable markets.

Enhancing Investor Protection and Market Stability

Investor protection and market stability remain central to the SEC's mission, and the agency will continue to modernize its structure, priorities and approach to address new opportunities and risks.

- TM will work to develop measures to improve the design, deployment, integrity, and operation of automated systems controlled by exchanges, other market centers and market participants. Additionally, TM will continue to advance efforts to ensure that market centers and market participants are prepared to respond quickly and effectively to system errors and malfunctions that may arise. The Division will continue to develop other improvements to the U.S. equity market structure.
- TM also will seek to advance improvements to the capital and customer protection framework for broker-dealers, including through enhanced audit procedures and updates to existing core rules.
- TM, in coordination with other divisions and offices, will work to improve its ability to quickly review and analyze market data, leveraging a new system that significantly expands data capabilities with respect to the structure of equity and equity options markets. TM also will continue to facilitate the self-regulatory organizations' development of a national market system plan for a consolidated audit trail.
- The Commission will work with the Financial Stability Oversight Council to evaluate potential threats to financial stability, including the susceptibility of money market mutual funds to runs.
- If funds are available, IM will aim to hire examiners to oversee funds and investment advisers. These examiners would increase investor protection by supplementing and coordinating with other examination efforts. They would also bring skills and specialized experience to examinations of funds and investment advisers. In addition, this specialization is expected to directly inform and support and improve policies and rulemakings that address industry practices observed during exams. The exam function will be part of a larger Office of Risk and Examination Group (REG), which will also conduct rigorous quantitative and qualitative financial analysis of the investment management industry to assist the Commission and the Division in carrying out their missions.
- Building on the success of the Aberrational Performance Model – which uses performance data to identify private fund advisers worthy of further review and which resulted in four cases being brought in 2012 – the Division of Risk, Strategy and Financial Innovation is currently developing an Accounting Quality Model to identify firms that have used unusually high levels of discretion in reporting earnings. This tool will aid the Office of Compliance

Inspections and Examinations in its risk-based exam approach and the Division of Enforcement's investigative efforts.

- The Division of Corporation Finance will continue to improve the quality of information provided to investors by focusing on disclosure by companies of the information most material to investment decision-making.

Rulemaking in Support of a More Dynamic Economy

The Dodd-Frank Act

The Dodd-Frank Act rulemaking process – informed by an unprecedented level of communication among the Commission and market participants of every type – continues to progress. The result will be a system that is more transparent, stable and responsive to the investors upon whom it rests. In 2013, the SEC expects to:

- Continue to implement the comprehensive regulatory framework for over-the-counter derivatives market called for by the Dodd-Frank Act, including the adoption of rules for regulation of market participants, mandatory clearing, and transaction reporting and execution, as well as rules establishing the SEC's approach to the cross-border aspects of that market.
- Continue to work with the banking regulators and the Commodity Futures Trading Commission to finalize a rule regarding the proprietary trading and fund investment activities of bank entities, commonly referred to as the "Volcker Rule".
- Work to finalize rules regarding improvements to the regulation of credit ratings and nationally recognized statistical rating organizations, as well as the removal of certain credit rating references in Commission rules.
- Finalize rules intended to better protect investors in the asset-backed securities (ABS) market, by improving the disclosure and offering process for ABS, including finalizing risk retention rules and rules requiring the disclosure of asset-level information required by the Dodd-Frank Act, and revising the criteria for ABS shelf registration eligibility.
- Propose and adopt rules to implement four executive compensation-related provisions of the Dodd-Frank Act that do not have statutory rulemaking deadlines. The rules mandate new listing standards relating to specified "clawback" policies, and new disclosure requirements regarding executive compensation and company performance, executive pay ratios, and employee and director hedging.
- Finalize rules that disqualify securities offerings involving certain "felons and other 'bad actors'" from relying on the safe harbor from Securities Act registration provided by Rule 506 of Regulation D.
- Adopt rules to require many of the entities that the SEC regulates to establish programs to detect and respond to indications of identity theft.
- Move forward with recommendations from a staff report to consider a uniform fiduciary standard of conduct for investment advisers and broker-dealers when providing personalized investment advice to retail investors about securities. In addition, the Commission will continue assessing ways to better harmonize the regulatory requirements of investment advisers and broker-dealers when they are providing the same or substantially similar services to retail investors.

The Jumpstart our Business Startups (JOBS) Act: Implementation and Beyond

The Commission and staff are also working to implement the JOBS Act in a practical manner that reflects the entrepreneurial dynamics of the digital age. This year the SEC will:

- Engage in rulemaking to implement the JOBS Act's provisions, including modifying the prohibition against general solicitation and general advertising in Rule 506 of Regulation D and Rule 144A under the Securities Act, and implementing exemptions under the Securities Act for "crowdfunding" offerings and unregistered public offerings of up to $50 million.
- Provide interpretive guidance to issuers and their advisors on the implementation and application of the JOBS Act.

- Complete a study required by Section 108, by finalizing review of Regulation S-K's requirements to determine how they may be updated to modernize and simplify the registration process and reduce the costs and other burdens for young companies.

Strengthening Stakeholder Communications

The SEC recognizes that close communications with market participants of every variety is critical to the effective execution of its mission. In addition to the dialogues that inform the rulemaking process, the Commission continues to search the regulatory structure for areas that might be improved, solicit stakeholder comment, and incorporate those comments into further recommendations – bringing the dialogue to a more focused level. In FY 2013, the Commission will:

- Develop recommendations for an interpretive release addressing issues raised in the July, 2010 "Proxy Plumbing" concept release about proxy advisory firms.
- Prepare a concept release for the Commission's consideration to seek comment on approaches to modernizing reporting by large holders under Section 13(d) and (g) of the Exchange Act.

Streamlining Operations and Finance

At a time of both growing institution responsibilities and limited budgets, increasing the SEC's ability to serve and protect investors depends in many ways on creating new efficiencies in operations that allow a greater share of resources to be devoted to mission-critical activities. Among the ways the agency will continue to find efficiencies:

- The SEC will reorganize the Office of Financial Management to best adapt to opportunities created by the successful migration of transactional services to a Federal Shared Service Provider. As a component of the effort to modernize EDGAR and filing fee review, the SEC's electronic filing and reporting system for registrants, the agency will consider new rules related to the administrative processing of Filing Fees and Registrant Deposits.
- The optimization of the SEC's procurement processes and conformity with GSA space utilization standards will yield continued cost savings for the agency.
- Maturing the SEC's operational risk management capability and internal control environment will be a strong focus in the coming year. The SEC also plans to pursue significant business process improvements and redesigns that address the opportunities for new efficiencies in paper based, manually intensive processes, particularly within the Human Resources, Financial Management, Support Operations, and Contracting areas.
- Improving employee engagement by implementing a "pay for performance" approach; instituting a next-generation leadership development program; and continuing to recruit a dynamic, innovative future workforce.
- Finally, the Commission will continue to capitalize on the great strides made in updating technology infrastructure and bring it in line with industry capability. This includes the important work already being done to modernize the public gateway to the SEC, SEC.gov, and EDGAR, while enhancing data management and analytics capabilities. The agency is also moving both primary and alternate data centers and their operations to external service providers in the coming year to improve efficiency and reduce costs.

In a financial marketplace that never stops evolving, the SEC is striving to change just as rapidly through better technology, more effective strategies, and a staff that never stops learning and whose performance never stops improving. The benefits to investors and markets are real and tangible. And next year, as the markets move forward and the SEC does as well, those benefits will be even greater.

Financial Highlights

This section provides an analysis of the financial position, results of operations, and the underlying causes for significant changes in balances presented in the SEC's FY 2012 financial statements. The tables in this section are summarized from the primary financial statements and may include minor rounding differences as compared to those statements.

As described further below, the SEC's finances have several main components:

- An annual appropriation from Congress;
- Securities transaction fees, charged in accordance with Section 31 of the Securities Exchange Act, which offset the agency's annual appropriation;
- An SEC Reserve Fund, which can hold up to $100 million to pay for SEC expenses but is not subject to annual appropriation or apportionment;
- Securities registration, tender offer and merger fees (also called filing fees) which are deposited into the Reserve Fund, up to $50 million in any one year not to exceed $100 million in total, with any excess of the limits deposited to the U.S. Treasury General Fund;
- Disgorgement and penalties ordered and collected from violators of the securities laws, some of which are then returned to harmed investors;
- The SEC Investor Protection Fund, which is funded through certain disgorgement and penalties not distributed to harmed investors, and which is used to make payments to whistleblowers who give tips to aid the SEC's enforcement efforts in certain circumstances, as well as to cover the expenses of the SEC Office of Inspector General's (OIG) Employee Suggestion Program.

Overview of Financial Position

Assets. At September 30, 2012, the SEC's total assets were $8,761 million, an increase of $244 million or 3 percent over FY 2011.

Fund Balance with Treasury (FBWT) increased by roughly $448 million. The change is mainly related to the collection of fees in excess of operating disbursements during the period

CHART 1.3
FY 2012 ASSETS BY TYPE

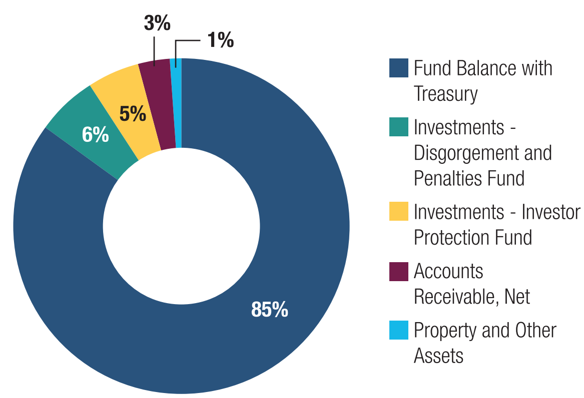


TABLE 1.2
ASSETS AS OF SEPTEMBER 30, 2012 AND 2011

(DOLLARS IN MILLIONS)	FY 2012	FY 2011
Fund Balance with Treasury	$ 7,444	$ 6,996
Investments – Disgorgement and Penalties Fund	522	750
Investments – Investor Protection Fund	452	453
Accounts Receivable, Net	237	214
Property and Equipment, Net	97	94
Other Assets	9	10
Total Assets	**$ 8,761**	**$ 8,517**

October 1, 2011 to September 30, 2012 and the increase in Disgorgement and Penalties FBWT, resulting from the SEC's change in investment strategy to retain more Disgorgement and Penalties resources as FBWT to more efficiently address future distribution requirements.

The decrease in Investments is attributed to distributions to harmed investors and the shift in investment strategy for Disgorgement and Penalty resources discussed above. Key distributions in FY 2012 include:

- Canadian Imperial Holdings, Inc.
- Banc of America Capital Management LLC
- Putnam Investment Management LLC
- Southwest Securities, Inc.
- PA Fund Management LLC
- Strong Capital Management Inc.

Liabilities. The SEC's total liabilities were $1,162 million at September 30, 2012, an increase of $56 million or 5 percent from FY 2011. The change is mainly related to the increase in the liabilities for Disgorgement and Penalties stemming from amounts assessed against violators of securities laws. The SEC recognizes a corresponding liability for the assets resulting from those judgments as they are non-entity assets held pending distribution to harmed investors.

The increase in Total Liabilities is partly offset by a decrease in Registrant Deposits of $13 million, which is mainly attributable to the SEC's efforts to review dormant registrant accounts and return unused funds to registrants or to Treasury as unclaimed funds.

Ending Net Position. The SEC's net position, comprised of both unexpended appropriations and the cumulative results of operations, increased by $188 million or 3 percent between September 30, 2011 and September 30, 2012. The increase is primarily due to SEC earning fee revenues in excess of program costs in its Salaries and Expenses and Reserve Funds, as discussed in the Results of Operations section on the next page.

CHART 1.4
FY 2012 LIABILITIES BY TYPE

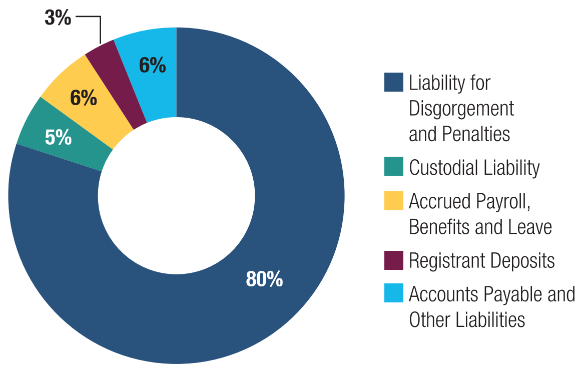


TABLE 1.3
LIABILITIES AS OF SEPTEMBER 30, 2012 AND 2011

(DOLLARS IN MILLIONS)	**FY 2012**	**FY 2011**
Liability for Disgorgement and Penalties	$ 933	$ 863
Custodial Liability	62	52
Accrued Payroll, Benefits and Leave	68	67
Accounts Payable	48	61
Registrant Deposits	34	47
Other Liabilities	17	16
Total Liabilities	**$ 1,162**	**$ 1,106**

Results of Operations

Earned Revenues. Total earned revenues for the year ended September 30, 2012 increased slightly ($4 million) over the total for FY 2011. Beginning in FY 2012, and as discussed below, the majority of the SEC's Filing Fees are now deposited to the U.S. Treasury General Fund upon collection and are no longer used to partially fund the SEC's operations.

Reserve Fund. Section 991(e) of the Dodd-Frank Act authorized the creation of a Securities and Exchange Commission Reserve Fund (Reserve Fund). Funded from filing fee collections, the SEC can deposit up to $50 million per fiscal year, and the fund cannot hold more than $100 million in total. Excess filing fees are deposited to the U.S. Treasury General Fund.

For the fiscal year ended September 30, 2012, filing fee revenues were $378 million. $50 million was deposited into the Reserve Fund, of which $25 million was temporarily rescinded. The excess of $328 million was deposited into the U.S. Treasury General Fund. In prior fiscal years, all filing fee collections created budget authority from offsetting collections and were used to partially fund SEC's operations. In FY 2012 and subsequent fiscal years, filing fee collections are no longer offsetting collections. Filing fees deposited to the Reserve Fund can be used to fund the SEC's operations, create budgetary authority, and are reported as a component of *Appropriations (Discretionary and Mandatory)* on the SEC's Statement of Budgetary Resources. Filing fees deposited to the U.S. Treasury General Fund cannot be used to fund the SEC's operations, do not create budgetary authority, and are reported as *Transferred to the General Fund* on the SEC's Statement of Changes in Net Position.

Program Costs. Total Program Costs were $1,198 million for the year ended September 30, 2012, an increase of $50 million or 4 percent when compared to the prior year. The SEC's Other Expenses increased $48 million when comparing FY 2012 to FY 2011. The SEC had increased expenses in the areas of information technology support, intra-agency agreements related to its transition to a Federal Shared Service Provider in FY 2012, and other contractual services.

TABLE 1.4
EARNED REVENUES FOR THE YEARS ENDED SEPTEMBER 30, 2012 AND 2011

(DOLLARS IN MILLIONS)	FY 2012	FY 2011
Section 31 Securities Transaction Fees	$ 1,270	$ 1,279
Securities Registration, Tender Offer, and Merger Fees (Filing Fees)	378	362
Other	–	3
Total Earned Revenue	**$ 1,648**	**$ 1,644**

CHART 1.5
FY 2012 FILING FEES REVENUE
(DOLLARS IN MILLIONS)

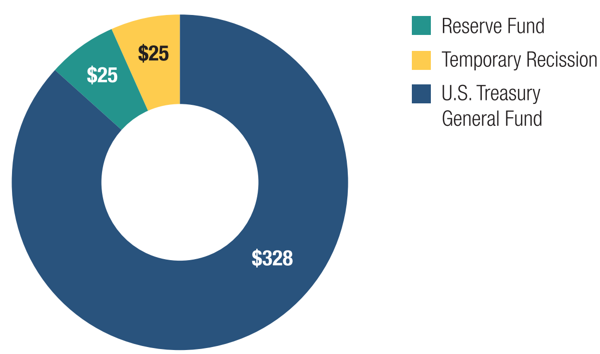
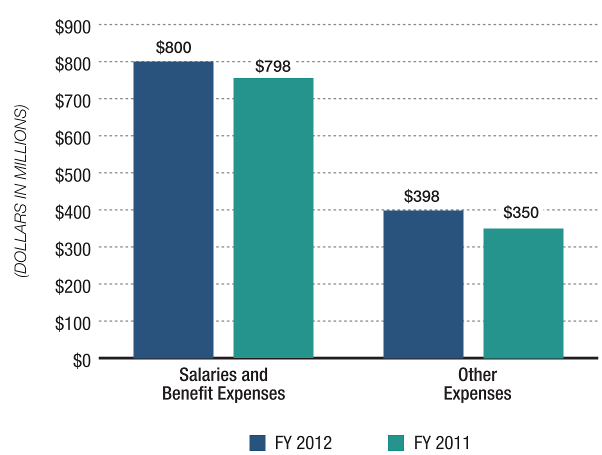


CHART 1.6
PROGRAM COSTS



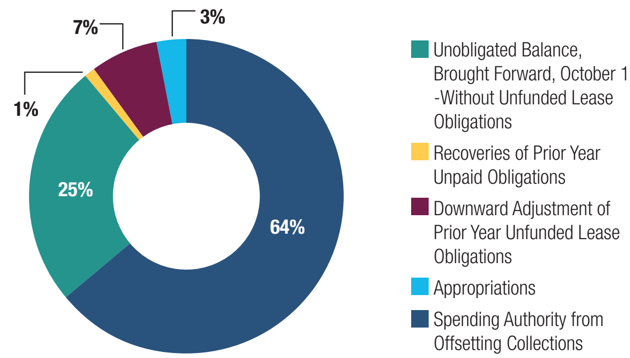
Budgetary Resources

In FY 2012, the SEC's total budgetary resources equaled $1,236 million, a 28 percent decrease from the FY 2011 amount of $1,713 million. Significant components of SEC's Total Budgetary Resources are described below.

Unobligated Balance Brought Forward – Unfunded Lease Obligations. The SEC's unobligated balance, brought forward was a negative $280 million for FY 2012. The balance includes the effect of the unfunded lease obligations recorded for 16 properties during FY 2011 totaling ($778) million to address issues noted in Comptroller General Decision B-322160, Securities and Exchange Commission - Recording of Obligation for Multiple-Year Contracts, and to accurately reflect leasing agreements in effect as of September 30, 2011. These unfunded obligations net against the resources derived from SEC's operating budget on an annual basis. Unfunded lease obligations totaled $523 million as of September 30, 2012. The reduction is related to downward adjustments (see below) totaling $142 million and funding actions of $113 million.

Downward Adjustments of Prior Year Unfunded Lease Obligations. The SEC recognized an unfunded obligation totaling $137.7 million for the Constitution Center lease in FY 2011. In June 2012, the SEC and U.S. General Services Administration (GSA) signed an agreement transferring responsibility for the Constitution Center lease to GSA. Based upon this agreement, the SEC recognized a downward adjustment totaling $137.7 million. Other downward adjustments are related to contractual changes resulting in lower estimated costs over the life of the leases.

CHART 1.7
FY 2012 SOURCES OF FUNDS



Percentages do not include the Unobligated Balance Brought Forward, October 1 – Interpretation for Lease Obligations

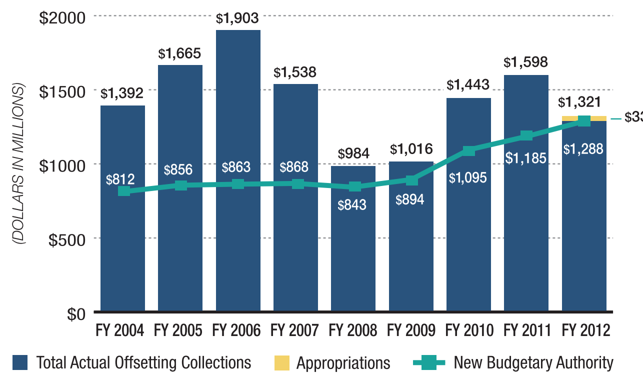
TABLE 1.5
TOTAL BUDGETARY RESOURCES FOR THE YEARS ENDED SEPTEMBER 30, 2012 AND 2011

(DOLLARS IN MILLIONS)	FY 2012	FY 2011
Unobligated Balance, Brought Forward, October 1:		
Salaries and Expenses Fund - Without Unfunded Lease Obligations	$ 47	$ 37
Interpretation for Lease Obligations	(778)	–
Investor Protection Fund	451	452
Unobligated Balance, Brought Forward, October 1:	(280)	489
Recoveries of Prior Year Unpaid Obligations	26	39
Downward Adjustments of Prior Year Unfunded Lease Obligations	142	–
Appropriation (Discretionary and Mandatory)		
Salaries and Expenses Fund	33	–
Reserve Fund	25	–
Investor Protection Fund	1	(1)
Spending Authority from Offsetting Collections	1,289	1,186
Total Budgetary Resources	**$ 1,236**	**$ 1,713**

Spending Authority from Offsetting Collections and Appropriations. The SEC's operating budget is primarily self-financed through the collection of Section 31 fees. In FY 2011 and prior fiscal years, filing fee collections also created budgetary authority from offsetting collections. However filing fees no longer create budget authority from offsetting collections. Refer to the Reserve Fund section on page 34 for additional information.

During the fiscal year, the SEC receives an appropriation to fund its operations. This appropriation establishes the SEC's new budget authority in its Salaries and Expenses Fund for the fiscal year. The SEC's new budget authority was $1,321 million for FY 2012. At the end of the fiscal year, SEC's Section 31 fee collections are used to offset the appropriation, and the appropriated authority is returned to the U.S. Treasury General Fund. The SEC's Section 31 fee collections totaled $1,288 million for FY 2012. Therefore, the SEC retained appropriated authority equal to $33 million. See *Chart 1.8, Offsetting Collections vs. New Budgetary Authority*[1].

CHART 1.8
OFFSETTING COLLECTIONS VS. NEW BUDGETARY AUTHORITY
SECTION 31 EXCHANGE AND FILING FEES



Investor Protection Fund

The SEC prepares stand alone financial statements for the Investor Protection Fund as required by the Dodd-Frank Act. The financial statements are presented starting on page 97. The Investor Protection Fund was established in the fourth quarter of FY 2010 to provide funding for a Whistleblower Award Program and to finance the operations of the OIG's Employee Suggestion Program.

The net position of the Investor Protection Fund increased by $641 thousand between the years ended September 30, 2012 and 2011. The Investor Protection Fund recognized non-exchange revenues totaling $757 thousand during FY 2012. The nonexchange revenue represents interest earnings on amounts invested in U.S. Treasury Securities. In addition, the Investor Protection Fund incurred expenses of $46 thousand for a whistleblower award and $70 thousand for salary and benefit costs in the OIG's Employee Suggestion Program.

TABLE 1.6
INVESTOR PROTECTION FUND ACTIVITY
FOR THE YEARS ENDED SEPTEMBER 30, 2012 AND 2011

(DOLLARS IN THOUSANDS)	**FY 2012**	**FY 2011**
Balance of Fund at beginning of preceding fiscal year	$452,788	$451,910
Amount deposited into or credited to the Fund during the preceding fiscal year	-	-
Amount of earnings on investments during the preceding fiscal year	757	990
Amount paid from the Fund during the preceding fiscal year to whistleblowers	(46)	-
Amount paid from the Fund during the preceding fiscal year for expenses incurred by Employee Suggestion Program	(70)	(112)
Balance of the Fund at the end of the preceding fiscal year	**$ 453,429**	**$ 452,788**

1 *Chart 1.8, Offsetting Collections vs. New Budgetary Authority, presents the SEC's budgetary authority derived from offsetting collections from fees collected on Section 31 securities transactions and Section 6(b), 13(e), 14(g) and 24f-2 filings (referred to as "filing fees") from FY 2004 through 2011. Pursuant to the Dodd-Frank Act and beginning in FY 2012, filing fee collections are no longer offsetting collections, and are now either deposited into the Reserve Fund or the U.S. Treasury General Fund. Thus, the FY 2012 column only presents amounts for Section 31 securities transaction fee collections. Amounts do not include reimbursable type collections and refunds as reported on the Spending Authority from Offsetting Collections line on the Statement of Budgetary Resources.*

Additional information regarding the Investor Protection Fund and Office of the Whistleblower is available in the 2012 Annual Report on the Dodd-Frank Whistleblower Program. This report may be found at *http://www.sec.gov/whistleblower.*

Limitations of the Financial Statements

The principal financial statements included in this report have been prepared by SEC Management to report the financial position and results of operations of the SEC, pursuant to the requirements of 31 U.S. Code Section 3515(b). While the statements have been prepared from the books and records of the SEC in accordance with GAAP for Federal entities and the formats prescribed by the Office of Management and Budget (OMB), the statements are in addition to the financial reports used to monitor and control budgetary resources, which are prepared from the same books and records. The statements should be read with the understanding that they are for a component of the U.S. Government, a sovereign entity.

Performance Highlights

The SEC's performance data provides a foundation for both programmatic and organizational decision-making and is critical for gauging the agency's success in meeting its objectives. The SEC is committed to using performance management best practices to promote greater accountability. This section provides information on its key performance measures for FY 2012. It outlines the SEC's strategic and performance planning framework, provides information on the costs incurred by the agency's four strategic goals and 10 national programs, and highlights the agency's progress toward reaching key performance targets.

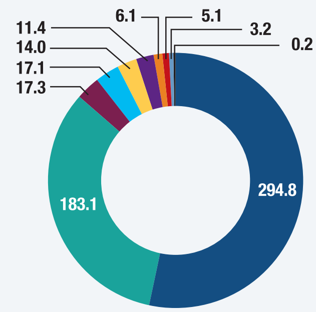
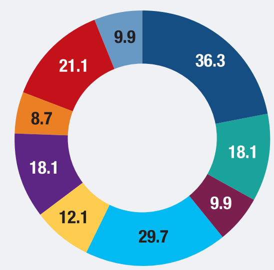
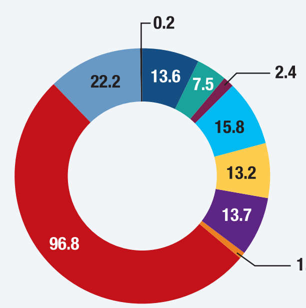
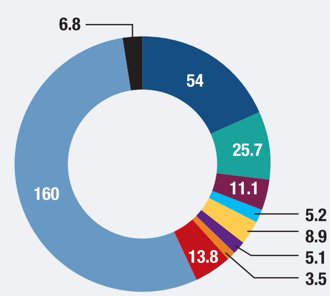
The SEC's FY 2012 Annual Performance Report (APR) will be issued with the agency's FY 2014 Congressional Budget Justification, and will provide a complete discussion of all of the agency's strategic goals, including a description of performance goals and objectives, data sources, performance results and trends, and information about internal reviews and evaluations. A summary on the SEC's verification and validation of all performance data also will be included in the APR. The SEC's APR is expected to be available in February 2013 at *http://sec.gov/about/offices/ofm/ofm-documents.htm*.

Strategic and Performance Planning Framework

The SEC's FY 2012 strategic and performance planning framework is based on the FY 2010 – FY 2015 Strategic Plan, available at *http://sec.gov/about/secstratplan1015f.pdf.* The Strategic Plan outlines the agency's mission, vision, values, and strategic goals and outcomes. The SEC's work is structured around four strategic goals, and 12 strategic objectives the agency plans to achieve in support of those four goals. The SEC's goals and priorities in the Strategic Plan are influenced by several external environmental factors, including global, complex and constantly evolving securities markets.

Table 1.7 displays the agency's FY 2012 costs for its four strategic goals and 12 strategic objectives, as well as how these costs are divided among the SEC's programs described in Table 1.1.

TABLE 1.7

Strategic Goal	Strategic Objective	Contributing Programs *($ in millions)*
Foster and enforce compliance with the Federal securities laws **Cost: $552.3 million**	The SEC fosters compliance with the Federal securities laws. Cost: $181.9 million	
	The SEC promptly detects violations of the Federal securities laws. Cost: $104.7 million	
	The SEC prosecutes violations of Federal securities laws and holds violators accountable. Cost: $265.7 million	
Establish an effective regulatory environment **Cost: $163.9 million**	The SEC establishes and maintains a regulatory environment that promotes high-quality disclosure, financial reporting, and governance, and that prevents abusive practices by registrants, financial intermediaries, and other market participants. Cost: $61.1 million	
	The U.S. capital markets operate in a fair, efficient, transparent, and competitive manner, fostering capital formation and useful innovation. Cost: $60.1 million	
	The SEC adopts and administers rules and regulations that enable market participants to understand clearly their obligations under the securities laws. Cost: $42.7 million	
Facilitate access to the information investors need to make informed investment decisions **Cost: $187.2 million**	Investors have access to high-quality disclosure materials that are useful to investment decision making. Cost: $129.5 million	
	Agency rulemaking and investor education programs are informed by an understanding of the wide range of investor needs. Cost: $57.7 million	
Enhance the Commission's performance through effective alignment and management of human, information, and financial capital **Cost: $294.1 million**	The SEC maintains a work environment that attracts, engages, and retains a technically proficient and diverse workforce that can excel and meet the dynamic challenges of market oversight. Cost: $72.8 million	
	The SEC retains a diverse team of world-class leaders who provide motivation and strategic direction to the SEC workforce. Cost: $59.6 million	
	Information within and available to the SEC becomes a Commission-wide shared resource, appropriately protected, that enables a collaborative and knowledge-based working environment. Cost: $49.4 million	
	Resource decisions and operations reflect sound financial and risk management principles. Cost: $112.3 million	

Enforcement · Compliance Inspections and Examinations · Corporation Finance · Trading and Markets · Investment Management · Risk, Strategy, and Financial Innovation · General Counsel · Other Program Offices · Agency Direction and Administrative Support · Inspector General

Performance Achievements

The SEC expended more than $1,197 million in FY 2012 to achieve its four strategic goals and 12 strategic objectives. Overall, the agency exceeded or met approximately 46 percent of its 72 planned performance targets. The percentage of performance targets that were met or exceeded for each strategic are outlined below in Table 1.8. (In calculating these figures, performance metrics for which no data was available were also included in the computation.)

TABLE 1.8

Strategic Goal	Foster and enforce compliance with the Federal securities laws	Establish an effective regulatory environment	Facilitate access to the information investors need to make informed investment decisions	Enhance the Commission's performance through effective alignment and management of human, information, and financial capital
% Performance Goal Targets Met or Exceeded	41%	53%	61%	33%

A detailed explanation of how the agency met or exceeded its planned performance targets, such as through increased efficiencies and improved processes, will be provided in the APR which will be published in February 2013. When a planned performance target was not met, the report will provide a description of actions that will be taken to achieve the target in the future.

This year, the SEC reaped significant benefits from its previous reforms to the national Enforcement and Examination programs. These reforms included creating specialized units, vastly expanding the SEC's training programs, hiring staff with new skill sets, streamlining management, and restructuring processes to ensure better sharing of information. The Enforcement program achieved a decrease in the average number of months between the opening of an investigation and the filing of the first action (Table 1.9). Additionally, the Commission obtained over $2.2 billion in FY 2012 in monetary relief from violators of the Federal securities laws, and the SEC's commitment to the timely collection and distribution of penalties and disgorgement funds is demonstrated in Table 1.10.

TABLE 1.9

PERFORMANCE GOAL
Average months between opening a matter under inquiry or an investigation and commencing an enforcement action

Description: This measure concerns the pace of investigations that lead to the filing of enforcement actions. Specifically, this measure captures average number months between the opening of an investigation and the filing of the first enforcement action arising out of that investigation. If the investigation was preceded by a matter under inquiry, the measure draws on the date of opening of the matter inquiry. In conducting investigations, the enforcement program continually strives to balance the need for complete, effective, and fair investigation with the need to file enforcement actions in as timely a manner as possible.

Fiscal Year	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012 Plan	FY 2012 Actual	FY 2012 Results
Months	Prior-year data not available				22	21	21	Met

Responsible Division/Office: Division of Enforcement

Data Source: HUB case management and tracking system for the Division of Enforcement

TABLE 1.10

PERFORMANCE GOAL Total amount distributed within the fiscal year, and the number of Fair Funds from which those distributions came								
Description: In its enforcement actions, the Commission may seek to return funds to harmed investors through disgorgement of ill-gotten gains or through the Fair Funds provision of the Sarbanes-Oxley Act. This provision permits the Commission to combine amounts paid as penalties with disgorged funds, or to create a Fair Fund from penalties only, to reduce losses to injured parties. This reflects the Commission's efforts to return funds to injured investors. This measure identifies the total amount distributed within the fiscal year, and the number of fair funds from which those distributions came. Due to the variation in reporting timelines established for each individual distribution, reported amounts are based on the agency's best available information. Reported amounts do not include those funds distributed through receiverships. Any funds not returned to investors are sent to the U.S. Treasury or the Investor Protection Fund established pursuant to Section 21F(g) of the Securities Exchange Act of 1934. Neither disgorgement nor penalties are used for the Commission's own expenses.								
Fiscal Year	**FY 2007**	**FY 2008**	**FY 2009**	**FY 2010**	**FY 2011**	**FY 2012 Plan**	**FY 2012 Actual**	**FY 2012 Results**
Amount Distributed (in millions)	Prior-year data not available					457	815	Exceeded
Number of Fair Funds	Prior-year data not available					63	31	Not Met
Responsible Division/Office: Division of Enforcement								
Data Source: Distributions Management System								

The SEC continued to spend considerable time and effort during the year on improving its risk assessment and surveillance capabilities to ensure that the National Exam Program (NEP) spent its limited time and resources on those firms presenting greater risk. The NEP's Risk and Qualitative Analysis units, as well as the Specialized Working Groups, continued to help identify risks to better target examinations.

Examinations of high risk firms often take significant time to complete and are frequently of large and complex entities. As a result, the staff did not examine the targeted amount of entities (Table 1.11). However, examination resources continued to be dedicated during the year to efforts, such as specialized training, intended to improve the long-term performance of the program. As noted below in Table 1.11, the NEP examined 8 percent of investment advisers in FY 2012. While not meeting the target goal of 9 percent, the investment advisers examined had 21 percent of the "regulatory assets under management" for the industry.

TABLE 1.11

PERFORMANCE GOAL Percentage of investment advisers, investment companies, and broker-dealers examined during the year								
Description: This measure indicates the number of registrants examined by the SEC or an SRO as a percentage of the total number of registrants. This measure includes all types of examinations: risk priority examinations, cause inspections to follow up on tips and complaints, limited-scope special inspections to probe emerging risk areas, oversight examinations of broker-dealers to test compliance and the quality of examinations by the Financial Industry Regulatory Authority (FINRA).								
Fiscal Year	**FY 2007**	**FY 2008**	**FY 2009**	**FY 2010**	**FY 2011**	**FY 2012 Plan**	**FY 2012 Actual**	**FY 2012 Results**
Investment advisers	13%	14%	10%	9%	8%	9%	8%	Not Met
Investment companies	20%	23%	29%	10%	13%	13%	12%	Not Met
Broker-Dealers (exams by SEC and SROs)	54%	57%	54%	44%	58%	55%	49%	Not Met
Responsible Division/Office: Office of Compliance Inspections and Examinations								
Data Source: Super Tracking and Reporting System (STARS) (IA, IC, and BD SEC data); SRO Databases (BD SRO Data); Tracking and Reporting Examinations – National Documentation Systems (TRENDS); and Commission filings								

Under the Federal securities laws, issuers are required to disclose material financial and other information to the public. In FY 2012, the SEC continued to meet the requirements of the Sarbanes-Oxley Act (Table 1.12) by reviewing the disclosures of about 33 percent of all reporting companies and investment company portfolios each year. This volume of disclosure review helped deter fraud and assured that investors had access to relevant information about emerging issues. In addition to reviewing filings of reporting companies, the SEC continued to issue initial comments on Securities Act filings in less than 30 days (Table 1.13).

TABLE 1.12

PERFORMANCE GOAL Percentage of public companies and investment companies with disclosures reviewed each year								
Description: The Sarbanes-Oxley Act requires that the SEC review the disclosures of all companies and investment company portfolios reporting under the Exchange Act at least once every three years. These reviews help improve the information available to investors and may uncover possible violations of the securities laws.								
Fiscal Year	**FY 2007**	**FY 2008**	**FY 2009**	**FY 2010**	**FY 2011**	**FY 2012 Plan**	**FY 2012 Actual**	**FY 2012 Results**
Corporations	36%	39%	40%	44%	48%	33%	48%	Exceeded
Responsible Division/Office: Division of Corporation Finance								
Data Source: Electronic Data Gathering, Analysis, and Retrieval (EDGAR)/Filing Activity Tracking System								
Investment Company Portfolios	38%	36%	35%	35%	33%	33%	36%	Exceeded
Responsible Division/Office: Division of Investment Management								
Data Source: Microsoft Office Suite Tools								

TABLE 1.13

PERFORMANCE GOAL Time to issue initial comments on Securities Act filings								
Description: The target of 30 days or less has become a de facto industry standard for the maximum time to receive initial comments.								
Fiscal Year	**FY 2007**	**FY 2008**	**FY 2009**	**FY 2010**	**FY 2011**	**FY 2012 Plan**	**FY 2012 Actual**	**FY 2012 Results**
Days	25.5 days	25.2 days	25.3 days	24.1 days	24.4 days	<30 days	24.9 days	Met
Responsible Division/Office: Division of Corporation Finance								
Data Source: Electronic Data Gathering, Analysis, and Retrieval (EDGAR)								

Given the immense size of the securities markets the SEC regulates, the agency's success in fulfilling its mission is highly dependent upon its ability to continually direct its resources towards the most productive uses for investors and the public. The SEC also is extremely mindful of its responsibility to maximize the impact of public funds. For the ninth year in a row the agency received an unqualified audit opinion, and for the second year in a row it had no material weaknesses (Table 1.14).

TABLE 1.14

PERFORMANCE GOAL Financial audit results								
Description: Under the Accountability of Taxpayer Dollars Act of 2002, the agency is required to meet all proprietary and budgetary accounting guidelines for Federal agencies and to undergo annual audits. The SEC's audits are conducted by the Government Accountability Office.								
Fiscal Year	**FY 2007**	**FY 2008**	**FY 2009**	**FY 2010**	**FY 2011**	**FY 2012 Plan**	**FY 2012 Actual**	**FY 2012 Results**
Unqualified Opinion	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Met
Material Weaknesses	1	0	1	2	0	0	0	Met
Significant Deficiency	3	3	6	0	4	0	2	Not Met
Responsible Division/Office: Office of Financial Management								
Data Source: GAO FY 2012 SEC Financial Audit Report								

Management Assurances

In FY 2012, the SEC demonstrated its continued commitment to maintaining strong internal controls. Internal control is an integral component of effective agency management, providing reasonable assurance that the following objectives are being achieved: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with laws and regulations. The Federal Managers' Financial Integrity Act of 1982 (FMFIA) establishes management's responsibility to assess and report on internal accounting and administrative controls. Such controls include program, operational, and administrative areas, as well as accounting and financial management. The FMFIA requires Federal agencies to establish controls that reasonably ensure obligations and costs are in compliance with applicable law; funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and revenues and expenditures are properly recorded and accounted for to maintain accountability over the assets. The FMFIA also requires agencies to annually assess and report on the internal controls that protect the integrity of Federal programs (FMFIA § 2) and whether financial management systems conform to related requirements (FMFIA § 4).

Guidance for implementing the FMFIA is provided through OMB Circular A-123. In addition to requiring agencies to provide an assurance statement on the effectiveness of programmatic internal controls and financial system conformance, the Circular requires agencies to provide an assurance statement on the effectiveness of internal control over financial reporting (ICFR).

Section 963 of the Dodd-Frank Act describes the responsibility of SEC management to establish and maintain adequate internal controls and procedures for financial reporting. Dodd-Frank requires an annual financial controls audit, an assessment of the effectiveness of internal control, and an attestation by the Chairman and the Chief Financial Officer. Section 922 of the Dodd-Frank Act requires the SEC to submit audited financial statements of the Investor Protection Fund to the Committee on Banking, Housing and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives.

The following Assurance Statement is issued in accordance with the FMFIA, OMB Circular A-123, and Section 922 and 963 of the Dodd-Frank Act.

Annual Assurance Statement

Assurance Statement On Internal Control Over Operations: The management of the SEC is responsible for establishing and maintaining effective internal control and financial management systems that meet the objectives of the Federal Managers' Financial Integrity Act of 1982. In accordance with OMB Circular A-123, the SEC conducted its annual assessment of the effectiveness of internal controls. Based on the results of the assessment for the period ending September 30, 2012, the SEC is able to provide an unqualified statement of assurance that the internal controls and financial systems, both for the agency as a whole and for the Investor Protection Fund, meet the objectives of the FMFIA. No material weaknesses were found in the design or operation of the internal controls for the fiscal year ended September 30, 2012.

Assurance Statement On Internal Control Over Financial Reporting: In accordance with Appendix A of OMB Circular A-123, the SEC conducted its assessment of the effectiveness of internal control over financial reporting, which includes safeguarding of assets and compliance with applicable laws and regulations. Based on the results of the assessment, the SEC is able to provide reasonable assurance that internal control over financial reporting, both for the agency as a whole and for the Investor Protection Fund, met the objectives of FMFIA and were operating effectively as of September 30, 2012, and that no material weaknesses were found in the design or operation of controls.

SEC also conducted reviews of its financial management systems in accordance with OMB Circular A-127, Financial Management Systems. Based on the results of these reviews, SEC can provide reasonable assurance that its financial management systems substantially comply with the requirements of the Federal Financial Management Improvement Act (FFMIA) as of September 30, 2012.

Mary L. Schapiro

Mary Schapiro
Chairman
November 15, 2012

Kenneth A. Johnson
Chief Financial Officer
November 15, 2012

Management's Responsibility for Internal Control

FMFIA requires the head of the agency, based on the agency's internal evaluation, to provide an annual Statement of Assurance on the effectiveness of their management, administrative, and financial reporting controls. OMB Circular A-123, *Management's Responsibility for Internal Control*, implements the FMFIA and defines management's responsibility for internal control in Federal agencies. The FY 2012 annual assurance statements for FMFIA and ICFR are provided on the preceding page.

FMFIA § 2 requires agencies to establish internal controls and financial systems which provide reasonable assurance that the following objectives are achieved:

- Effective and efficient operations;
- Compliance with applicable laws and regulations; and
- Reliability of financial reporting.

The Chairman's FMFIA assurance statement is primarily based on individual assurance statements from each division director and office head. The individual statements assessed internal controls related to the effectiveness of the controls over programs and operations, financial reporting, and compliance with laws and regulations and were based on self-assessments and internal reviews, as well as Office of the Inspector General (OIG) and Government Accountability Office (GAO) reviews, audits, inspections, and investigations.

The results of these statements were considered with other sources of information when determining whether any management control deficiencies or non-conformances needed to be reported in the annual assurance statement. Other information sources included, but were not limited to, the following:

- An entity-level control assessment;
- Internal management reviews, self-assessments, and tests of internal controls;
- Management's personal knowledge gained from daily operations;
- Reports from the GAO and the OIG;
- Reviews of financial management systems under OMB Circular A-127, Financial Management Systems;
- Annual performance plans and reports pursuant to the Federal Information Security Management Act (FISMA) and OMB Circular A-130, Management of Federal Information Resources;
- Annual reviews and reports pursuant to the Improper Payments Elimination and Recovery Act;
- Reports and other information from Congress or agencies such as OMB, the Office of Personnel Management (OPM), or GSA, reflecting the adequacy of internal controls; and
- Additional reviews relating to a division or office's operations, including those discussed in the Other Reviews section below.

FMFIA § 4 requires that agencies annually evaluate and report on whether financial management systems conform to government-wide requirements. The SEC evaluated its financial management systems for the fiscal year ending September 30, 2012, in accordance with the FFMIA and OMB Circular A-127, *Financial Management Systems*, as applicable.

Appendix A of OMB Circular A-123 requires the agency head to provide a separate statement of assurance on the effectiveness of ICFR, in addition to the overall FMFIA assurance statement. SEC management assessed internal control at the entity-level, process, transaction, and application level. This report also provides a Summary of Financial Statement Audits and Management Assurances under the section entitled Other Accompanying Information, as required by OMB Circular A-136, *Financial Reporting Requirements*.

The effectiveness of process level controls was assessed through detailed test procedures related to the agency's financial reporting objectives. As part of this effort, the agency performed a comprehensive risk assessment in which SEC management identified:

- Significant financial reports;
- Significant line items and accounts;
- Major classes of transactions;
- Relevant assertions, risks of material misstatement and control objectives;

- Reporting and regulatory requirements; and
- Existing deficiencies and corrective action plans.

From the results of the risk assessment, SEC management selected processes fundamental to the agency's financial management. SEC management updated documentation of the business processes and control activities designed to mitigate significant financial reporting and compliance risks.

These control activities were tested for design and operating effectiveness. The agency also tested the operating effectiveness of control activities that were found to be deficient in prior years. The test results served as a basis for management's assessment of the effectiveness of ICFR.

The results of testing completed prior to and as of September 30th formed the basis of the annual management assurance statement. SEC management also analyzed the magnitude of the internal control deficiencies and the level of assurance provided under the FMFIA requirements. SEC management analyzed the internal control deficiencies, both individually and in the aggregate, to determine if a significant deficiency or a material weakness[1] existed in the financial reporting processes.

Significant factors considered for assessing each deficiency included the following:

- Nature of the control deficiency (e.g., design, operation);
- Internal control objectives and activities impacted;
- Potential impact on financial statement line items, accounts, and disclosures;
- The interaction of control deficiencies with other deficiencies; and
- The materiality of account balances impacted by the deficiency.

Each year, the agency's Financial Management Oversight Committee (FMOC) advises the Chairman as to whether the SEC had any deficiencies in internal control or financial system design significant enough to be reported as a material weakness or non-conformance. This advice is based on the assurance statements from directors and office heads and other supplemental sources of information.

Other Reviews

GAO audited the SEC's financial statements. The objective of GAO's audit was to express an opinion on the financial statements and on ICFR and to report on tests of compliance with selected laws and regulations.

The OIG conducted eight audits and reviews during the fiscal year. The reviews covered 10 of the 36 assessable units (28 percent). Some components had multiple reviews.

Financial Management System Conformance

The FFMIA requires that each agency implement and maintain financial management systems that comply substantially with Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Standard General Ledger at the transaction level. The purpose of the FFMIA is to advance Federal financial management by verifying that financial management systems provide accurate, reliable, and timely financial management information. Although the SEC is exempt from the requirement to determine substantial compliance with FFMIA, the agency assesses its financial management systems annually for conformance with the requirements of OMB Circular A-127 and other Federal financial system requirements.

The SEC's process to assess its financial management systems was in compliance with the January 9, 2009 revision of OMB Circular A-127 and included the use of an FFMIA risk model which ranked risks from nominal to significant. Based on the results of the review, the SEC concluded that its risk rating was nominal. Upon the review of the criteria in OMB Circular A-127 for agencies with nominal risk, the SEC determined its financial core and mixed systems are in substantial compliance with Section 803(a) of the FFMIA requirements. This was based in part on notable progress made by SEC management and staff in implementing remediation activities in response to four significant deficiencies in ICFR noted in FY 2011. The SEC assessed each of its core and mixed financial systems to determine the risk category. The systems were reviewed individually for compliance, and then collectively a risk rating was determined for the agency's system compliance. The SEC performed an assessment of the FFMIA risk indicators and

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1 *A material weakness is a significant deficiency, or combination of significant deficiencies, that create a reasonable possibility that program objectives are not met, or results in the risk of control failure not being mitigated.*

classified its financial systems as being in the nominal risk category.

Summary of Current Financial System and Future Strategies

The FY 2012 ICFR assessment demonstrated that a nominal rating would be appropriate for the seven risk indicators and therefore it was concluded that the agency substantially complies with the requirements of Section 803(a) of the FFMIA. The SEC's core financial systems during FY 2012, Momentum and Delphi, are both Financial Systems Integration Office (FSIO) certified systems and met all of the requirements of FFMIA.

During FY 2012, in an effort to reduce dependency on manual, non-integrated financial sub-processes, the SEC completed its migration from its core financial system, Momentum, to an FSSP. The SEC has historically relied heavily on non-integrated spreadsheets and desktop databases for key input into financial reporting which are, by their nature, difficult to secure and prone to error. Because of this, in FY 2012 the agency subjected key non-integrated spreadsheets and desktop databases to risk assessment and application of controls. Through the use of the FSSP, the SEC also has sought to eliminate some of its manual processes to consolidate them within the capabilities of the new system. Because of such efforts, the SEC has reduced the number of user-developed applications significantly.

The SEC continued to improve its general support system (GSS) security controls affecting the financial systems servers. While this assessment noted deficiencies in some areas, there was substantial progress made from the prior year and the assessment identified no significant deficiency in the area of information security.

Federal Information Security Management Act (FISMA)

FISMA requires Federal agencies to "develop, document, and implement an agency-wide information security program…to provide information security for the information and information systems that support the operations and assets of the agency, including those provided or managed by another agency, contractor, or other source". In addition, FISMA requires Federal agencies to conduct annual assessments of their information security and privacy programs, to develop and implement remediation efforts for identified weaknesses and vulnerabilities, and to report compliance to OMB. The SEC's OIG, Chief Information Security Officer, and Privacy Officer annually perform a joint review of the Commission's compliance with FISMA requirements. The Commission will submit its 2012 report to OMB on November 15, 2012, as required.

In FY 2012, the SEC Office of Information Technology (OIT), in conjunction with system owners, completed assessment and authorization activities for 18 of 59 reportable systems which are on a three year rotational cycle, in accordance with OMB policy and guidance from the National Institute of Standards and Technology (NIST). OIT completed contingency testing on the majority of the SEC's authorized systems as part of disaster recovery exercises, unscheduled events and weather occurrences. OIT Security's assessment team visited three of the 11 SEC Regional Offices as part of a three-year review cycle and performed a technical assessment of both the local network infrastructure and physical security. The assessment team also conducted a disaster recovery simulation exercise at the three Regional Offices. The SEC user community achieved 100 percent completion of the annual information security awareness and privacy training sessions.

OIT refined its privacy analysis and as a result, 141 privacy reviews were conducted during FY 2012, which included the approval and publishing of 11 privacy impact assessments (PIAs), and four systems of records notices; and the adopting of rulemaking amending the SEC's Privacy Act Regulations.

OIT continued to provide supplemental training regarding the safe handling of personally identifiable information to SEC staff and contractors in SEC regional offices, as recommended by OIG. In addition, as part of its privacy awareness campaign this fiscal year, OIT implemented additional measures to raise employee awareness about the importance of data privacy, individual privacy rights and the prevention of improper use or disclosure of personally identifiable information through publishing a quarterly, e-newsletter and an e-brochure.

SEC continues to explore cloud computing technologies and solutions based on information protection requirements.

Financial Section

This section of the Agency Financial Report contains the U.S. Securities and Exchange Commission's (SEC) financial statements, required supplementary information, financial statements for the Investor Protection Fund, and the related Independent Auditor's Report. Information presented here satisfies the financial reporting requirements of the Accountability of Tax Dollars Act of 2002 and Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

The SEC prepares these statements in conformity with U.S. generally accepted accounting principles (GAAP) for the Federal Government and OMB Circular A-136, *Financial Reporting Requirements*.

The section contains the Government Accountability Office's (GAO) audit opinion, followed by the SEC's response. Then, the section shows the required financial statements for the SEC. The statements provide a comparison of fiscal year (FY) 2012 and FY 2011 information. The SEC prepares the following required financial statements.

- Balance Sheet – presents, as of a specific time, amounts of future economic benefits owned or managed by the SEC (assets), amounts owed by the entity (liabilities), and amounts which comprise the difference (net position).
- Statement of Net Cost – presents the gross cost incurred by the SEC less exchange revenue earned from its activities, including registration and filing fees. The SEC presents net cost of operations by program to provide cost information at the program level. The SEC recognizes collections as exchange revenue on the Statement of Net Cost, even when the collections are transferred to other entities.
- Statement of Changes in Net Position – reports the change in net position during the reporting period. This statement presents changes to Cumulative Results of Operations.
- Statement of Budgetary Resources – provides information about how budgetary resources were made available as well as their status at the end of the year.
- Statement of Custodial Activity – reports the collection of revenue for the Treasury General Fund. The SEC accounts for sources and disposition of the collections as custodial activities on this statement. Custodial collections of non-exchange revenue, such as amounts collected from violators of securities laws as a result of enforcement proceedings, are reported only on the Statement of Custodial Activity.

The SEC does not have stewardship over resources or responsibilities for which supplementary stewardship reporting would be required.

Budgetary information aggregated for purposes of the Statement of Budgetary Resources is disaggregated for each of the SEC's major budget accounts and is presented as Required Supplementary Information.

The accompanying Notes to the Financial Statements provide a description of significant accounting policies as well as detailed information on select statement lines.

This section contains stand alone, comparative financial statements and accompanying notes for the Investor Protection Fund as required by the Dodd-Frank Act. These statements include the Balance Sheet, Statement of Net Cost, Statement of Changes in Net Position, and Statement of Budgetary Resources.

Message from the Chief Financial Officer

I am delighted to join Chairman Schapiro in presenting the SEC's Agency Financial Report (AFR) for fiscal year (FY) 2012. We hope you find the AFR a useful summary of the SEC's use of resources, operating performance, financial stewardship, and internal control.

I am pleased to report that the SEC has succeeded in completing its transition to a Federal Shared Service Provider (FSSP) model, engaging with the Department of Transportation's Enterprise Service Center (ESC). Through this initiative, the SEC aims to achieve improvements in system functionality, automation of some manual processes and further enhancements to financial management and reporting.

In addition, three previously identified significant deficiencies in the areas of financial reporting and accounting processes, information security, and registrant deposits and filing fees were successfully mitigated in 2012. We achieved these results by:

- Enhancing controls over the spreadsheets and databases used by the agency for material financial reporting-related transactions, based on the level of risk they posed to accurate financial reporting.

- Implementing enhanced continuous monitoring procedures over system access, along with an enhanced risk management strategy. Further, we have transitioned the security over the financial system to ESC, which will now perform the necessary security updates and patching.

- Eliminating the backlog of registrant accounts that have seen no activity in the previous three years, by reviewing the account history where appropriate and returning the funds to registrants or the Treasury. Additional controls have also been put into place to monitor and review accounts that are approaching three years without any activity.

The SEC continues to address the remaining significant deficiency from 2011 in the area of budgetary resources. The agency made a significant stride forward in this area in FY 2012 because of its migration to the FSSP systems, which included an interface between the procurement system and the financial system. This interface will help address the timeliness and errors in recording obligations that were inherent in our previous manual processes. The agency also made progress this year in identifying contracts that could be de-obligated. However, further work will be necessary to optimize the processes for committing and obligating funds, as well as for monitoring obligations to determine which ones can be deobligated.

A new significant deficiency was also identified this year in the area of property and equipment. Since this area impacts multiple offices within the agency, we are working collectively to strengthen front-end controls over the procuring, tracking and accounting for property. More specifically, we plan to tighten controls over the receipt, accounting, and inventories of property and equipment.

While we have made significant strides in the SEC's multi-year path towards a strong, sustainable internal control posture, the agency will continue to dedicate its energies towards remediating our remaining deficiencies. The SEC's Office of Financial Management has undergone an external organizational assessment, and is implementing a new organizational structure, including the formalization of a function to regularly monitor transactional data. Further, the SEC will work to optimize its processes under the new FSSP environment, and look for further opportunities to gain efficiencies in those processes.

This section of the Annual Financial Report displays the SEC's financial statements and notes, both for the entity as a whole and for the Investor Protection Fund, as required under Section 922 of the Dodd-Frank Act. It also contains the results of the FY 2012 audit conducted by the U.S. Government Accountability Office, as well as the agency's response. These documents are important because they give the public an important view into the state of the SEC's finances and its internal controls over financial reporting. We hope you find this information helpful and informative.

Sincerely,

Kenneth A. Johnson
Chief Financial Officer
November 15, 2012

Report of Independent Auditors

GAO
Accountability • Integrity • Reliability
United States Government Accountability Office
Washington, D.C. 20548

Independent Auditor's Report

To the Chairman of the United States Securities and Exchange Commission

We agreed, under our audit authority, to audit the financial statements of the United States Securities and Exchange Commission (SEC) and its Investor Protection Fund (IPF). The Securities Exchange Act of 1934, as amended in 2010 by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act),[1] requires that SEC provide separate annual audited financial statements for IPF to Congress.[2] IPF's financial transactions are also included in SEC's overall financial statements. Further, in accordance with the Dodd-Frank Act, we are assessing the effectiveness of SEC's internal control over financial reporting, evaluating SEC's assessment of such effectiveness, and attesting to SEC's assessment of its internal control over financial reporting. In our audits of SEC's financial statements and IPF's financial statements for fiscal years 2012 and 2011, we found

- the financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles;
- although internal controls could be improved, SEC maintained, in all material respects, effective internal control over financial reporting as of September 30, 2012; and
- no reportable noncompliance in fiscal year 2012 with provisions of laws and regulations we tested.

The following sections discuss in more detail (1) these conclusions; (2) required supplementary information and other information included with the financial statements; (3) our audit objectives, scope, and methodology; and (4) SEC's comments on a draft of this report.

Opinion on SEC's Financial Statements

SEC's financial statements, including the accompanying notes, present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, SEC's assets, liabilities, and net position as of September 30, 2012 and 2011, and

[1]Pub. L. No. 111-203, § 963(a), (b)(2), 124 Stat. 1376, 1910 (2010), *codified at* 15 U.S.C. § 78d-8(a), (b)(2).
[2]Section 21F(g)(5) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u-6(g)(5).

its net cost of operations, changes in net position, budgetary resources, and custodial activity for the fiscal years then ended.

Opinion on IPF's Financial Statements

IPF's financial statements, including the accompanying notes, present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, IPF's assets, liabilities, and net position as of September 30, 2012 and 2011, and its net cost of operations, changes in net position, and budgetary resources for the fiscal years then ended.

Opinions on Internal Control

Although certain internal controls could be improved, SEC maintained, in all material respects, effective internal control over financial reporting as of September 30, 2012, for SEC and IPF. These controls provided reasonable assurance that misstatements, losses, or noncompliance material in relation to the agency's overall financial statements and IPF's financial statements would be prevented or detected and corrected on a timely basis. Our opinions are based on criteria established under 31 U.S.C. § 3512(c), (d), commonly known as the Federal Managers' Financial Integrity Act of 1982 (FMFIA). Our opinions on SEC's internal control are consistent with SEC's assertion that its internal controls over financial reporting, both for the agency as a whole and for IPF, were operating effectively as of September 30, 2012, and that no material weaknesses were found in the design or operation of the controls.[3]

However, as discussed in greater detail later in this report, our fiscal year 2012 audit identified continuing and new deficiencies in SEC's internal control over financial reporting relating to budgetary resources and property and equipment that constituted significant deficiencies.[4] These significant deficiencies pertained to SEC's overall financial reporting, but not that of IPF because of the nature of IPF's financial transactions during fiscal year 2012.

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[3]Dodd-Frank Act, Pub. L. No. 111-203, § 963, 124 Stat. 1376, 1910 (2010), *codified at* 15 U.S.C. § 78d-8, requires that (1) SEC submit annual reports to Congress describing management's responsibility for internal control over financial reporting and assessing the effectiveness of such internal control during the fiscal year, (2) the SEC Chairman and Chief Financial Officer attest to SEC's reports, and (3) GAO attest to and report on the assessment made by SEC. SEC conducted an evaluation of its internal control over financial reporting in accordance with the Office of Management and Budget's (OMB) Circular No. A-123, *Management's Responsibility for Internal Control*, based on criteria established under FMFIA.

[4]A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis.

Specifically, while SEC addressed some of the issues constituting significant deficiencies in the accounting and related financial reporting for budgetary resources that we reported in fiscal year 2011,[5] our work in fiscal year 2012 identified both continuing and new deficiencies in the design or implementation of internal control over accounting for budgetary resources that were significant to SEC's financial reporting as of September 30, 2012. We considered these continuing and new deficiencies to represent a significant deficiency in SEC's internal control over financial reporting for budgetary resources in fiscal year 2012.

During fiscal year 2012, we also determined that deficiencies in SEC's controls over accounting for its property and equipment constituted a significant deficiency. We have reported on deficiencies in SEC's controls over accounting for its property and equipment in prior audits and have provided SEC with recommendations to address these deficiencies.[6] SEC has taken actions related to some of these previously reported deficiencies. However, our work identified new and continuing deficiencies in the design or implementation of SEC's internal control over accounting for property and equipment as of September 30, 2012.

The significant deficiencies in accounting for budgetary resources and property and equipment, although not considered to be material weaknesses, are important enough to merit the attention of those charged with governance of SEC. Additional details concerning these two significant deficiencies are discussed later in this report. For all significant errors and issues that were identified, SEC made necessary adjustments to the financial statements, the notes accompanying the financial statements, and other required supplementary information, as appropriate. Consequently, SEC was able to prepare financial statements that were fairly presented in all material respects for fiscal years 2012 and 2011. Although the significant deficiencies in internal control did not materially affect SEC's fiscal year 2012 financial statements, misstatements may occur in other financial information reported by SEC and not be prevented or detected and corrected on a timely basis because of these significant deficiencies.

During fiscal year 2012, SEC made notable progress in addressing other internal control deficiencies we reported in fiscal year 2011. Specifically, SEC sufficiently addressed the deficiencies in its information security, financial reporting and accounting process, and registrant deposit and filing fee transactions such that we no longer consider the remaining control deficiencies in these areas, individually or collectively, to represent significant deficiencies as of September 30, 2012.

We also identified other deficiencies in SEC's system of internal control that we do not consider to be material weaknesses or significant deficiencies but that also merit SEC management's attention and correction. We have communicated these matters to SEC management and, as appropriate, will be reporting them separately to SEC, along with recommendations for corrective actions.

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[5]GAO, *Financial Audit: Securities and Exchange Commission's Financial Statements for Fiscal Years 2011 and 2010*, GAO-12-219 (Washington, D.C.: Nov. 15, 2011).
[6]GAO, *Financial Audit: Securities and Exchange Commission's Financial Statements for Fiscal Years 2008 and 2007*, GAO-09-173 (Washington, D.C.: Nov. 14, 2008).

Significant Deficiency over Budgetary Resources

As we have reported in prior years, during fiscal year 2012, we continued to find deficiencies in SEC's internal control over accounting for budgetary resources. Specifically, we continued to find general ledger system configuration deficiencies and deficiencies over the recording of obligations, monitoring of obligations, and deobligating of obligations that were no longer valid. As part of its strategy to address its control deficiencies, in fiscal year 2012, SEC migrated its core financial system—relied on to support financial reporting on its budgetary resources—to a shared service provider. This improved SEC's capability to integrate its contract award process with the recording of obligations in its financial records, but these efforts did not address the general ledger system configuration deficiencies or the deficiencies in the recording of new obligations and monitoring of obligations that we have reported in previous years. Specifically, 11 of the 13 recommendations we reported in prior years resulting from control deficiencies over budgetary resources had not been effectively addressed by SEC as of September 30, 2012. In addition, this year we found inadequate controls over SEC's conversion of obligations to its new shared service provider's financial system and other new internal control deficiencies, including inadequate review procedures and reconciliation controls, that resulted in errors in SEC's Statement of Budgetary Resources (SBR) at June 30, 2012.

Specifically, our fiscal year 2012 audit found that SEC's shared service provider's general ledger system did not have the capability to record deobligation[7] transactions as these occur. As a result, the conversion to a new financial system did not resolve the general ledger configuration deficiencies that we reported in previous years. To help compensate for this, SEC developed a process for identifying and recording deobligation activities in the financial records and posting these transactions as adjusting entries prior to closing its financial records for the year. However, SEC did not develop and implement this process until September 2012, and it was still not fully documented as of year-end.

We also identified continuing deficiencies in controls over the recording of new obligations and the monitoring of obligations. For example, of the 45 new obligations we tested, we found that 4 did not have proper certification of availability of funds prior to the recording of the obligation and 2 were not recorded within prescribed time frames. These kinds of deficiencies could potentially result in Antideficiency Act[8] violations if budgetary resources are no longer available for the new obligations. In addition, our test of 45 recorded deobligations found that 20 were not deobligated within prescribed time frames, ranging from 7 months to about 5 years after the period of performance had expired. Further, our testing also identified obligations that were no longer valid but that had not been deobligated, resulting in a projected

[7]Deobligation refers to an agency's cancellation or downward adjustment of previously incurred obligations. Deobligated funds may be reobligated within the period of availability of the appropriation. For example, annual appropriated funds may be reobligated in the fiscal year in which the funds were appropriated, while multiyear or no-year appropriated funds may be reobligated in the same or subsequent fiscal years.
[8]31 U.S.C. §§ 1341, 1342, 1351, 1571.

likely misstatement of over $16 million to the June 30, 2012, balance of reported obligations. Timely deobligation of resources is important to an agency to free up resources that may be made available to fund high-priority agency mission objectives or used to provide resources to fund increases to existing activities. SEC's own internal control evaluation process for fiscal year 2012 also identified continuing control deficiencies in this area.

We also found a new deficiency in SEC's controls related to its conversion of its budgetary account balances into the new financial system. Specifically, we found numerous obligations that were not properly and accurately converted into the new system. There were numerous contracts where invoices that were paid were not matched against appropriate contract line items, which could cause the obligation and unliquidated balances to be incorrect and result in delays in the deobligation of the contract. In addition, adjustments made to correct certain duplicate shipping information resulted in the recording of duplicate obligations of about $3 million at June 30, 2012. Further, as a compensating control, for 6 weeks during the conversion, SEC used a spreadsheet to track obligations that could not be recorded in the financial systems to determine the dollar amount of accrual adjustments for obligations that should be recorded for financial reporting purposes. However, this manual process did not identify all obligations. In September 2012, SEC performed a review of all requisitions in the contract award system. Based on this review, SEC estimated that an additional $5 million of obligations that were not included in these manual spreadsheets should have been recorded in the financial records as of June 30, 2012. SEC's own internal control evaluation recommended SEC management's continued attention on remaining conversion issues resulting from the migration of the obligations into the new financial system.

In fiscal year 2012, we also found that SEC did not have a control to reconcile its budget subsidiary ledger module to the related general ledger account balances as of June 30, 2012, and that SEC's controls over reviewing journal entry adjustments were not consistently effective. We found that SEC's apportioned unobligated balance reported in the June 30, 2012, SBR was understated by about $42 million because SEC did not properly record the reapportionment of prior year unobligated balances and current year recoveries from deobligations. Had SEC had an effective process in place to reconcile its budget execution module (subsidiary ledger) with the related general ledger accounts, this error should have been timely detected. SEC posted an adjustment to properly record this transaction and implemented a control procedure to reconcile the budget module to the general ledger as of September 30, 2012. In addition, SEC's process for reviewing adjusting journal entries did not identify that SEC's recoveries from deobligation of prior year obligations related to lease obligations were understated by about $141 million in the SBR at June 30, 2012.[9] Instead of accounting for these transactions as recoveries from the deobligation of prior year obligations, as required by generally accepted

[9]In fiscal year 2011, SEC recorded $778 million in additional obligations to recognize its full lease obligations pursuant to a GAO legal decision concerning SEC's multiyear leasing authority. (B-322160, Oct. 3, 2012.) Refer to note 14 (Status of Budgetary Resources*)* of the financial statements for a further discussion of this issue. In fiscal year 2012, $137.7 million of these obligations were deobligated when SEC entered into an agreement with the General Services Administration transferring responsibility for the related property.

accounting principles, SEC recorded these transactions as direct reductions in the obligation balance.[10] Supervisory review of the journal entries for these transactions did not detect these errors. Subsequent to June 30, 2012, SEC requested guidance from the Office of Management and Budget regarding the proper accounting treatment for downward adjustments of unfunded lease obligations and posted an adjustment to properly record the transaction. Although we did not identify errors in our testing of balances as of September 30, 2012, and SEC corrected the specific errors we identified during our interim testing, ineffective review of journal vouchers increases SEC's risk of future misstatements being recorded in the general ledger and reported in the SBR.

Collectively, the continuing and new deficiencies discussed above represent a significant deficiency in internal control over budgetary resources for fiscal year 2012.

Significant Deficiency over Property and Equipment Controls

SEC's property and equipment consist of general-purpose equipment used by the agency, capital improvements made to buildings leased by SEC for office space, and internal-use software development costs for projects in development and production. SEC acquired approximately $40 million in property and equipment during fiscal year 2012. We have reported deficiencies in SEC's controls over property and equipment in prior years, including inaccuracies in capitalizing amounts for internal-use software projects, inaccuracies in recording acquisition costs, and unrecorded property and equipment purchases. In fiscal year 2008, we concluded that these and other deficiencies collectively represented a significant deficiency in controls over the recording of property and equipment transactions. In fiscal year 2009, SEC took action to address these deficiencies such that we no longer considered the remaining deficiencies to collectively represent a significant deficiency in fiscal years 2009 through 2011. However, our testing results this year identified new deficiencies that combined with the remaining control deficiencies from our fiscal year 2009 audit, represent a significant deficiency in SEC's internal controls over property and equipment transactions as of September 30, 2012. Specifically, SEC's controls did not ensure that property transactions were consistently recorded timely or accurately in the general ledger. We also identified deficiencies in SEC's physical inventory procedures and ongoing oversight and monitoring controls over property transactions.

During the course of testing fiscal year 2012 property transactions, we found that SEC's controls were not fully effective in ensuring that property and equipment purchases were recorded timely and accurately in SEC's general ledger. Specifically, we identified over $5 million in capitalized assets that were received and placed in service in fiscal year 2011 but not capitalized until fiscal year 2012, as a

[10] OMB Circular A-11 states that deobligations (downward adjustments to prior year obligations) should be recorded when the price is adjusted.

result of deficiencies in SEC's process for ensuring that assets received close to year-end are timely recorded. These items were not accrued for at the end of fiscal year 2011 or included in SEC's prior period adjustment analysis[11] at June 30, 2012. Similarly, we identified an internal-use software project that was placed into service in May 2011 but not recorded in the general ledger system until September 2012. As a result of these errors, depreciation expense was overstated in fiscal year 2012. During our testing, we also found errors in recorded acquisition costs. For example, we identified five assets for which the capitalized cost erroneously included maintenance and service costs. Although these transactions were recorded in October 2011, SEC did not identify and correct the errors through its detective controls until February 2012. Our year-end testing continued to identify a significant number of manual adjustments that SEC recorded to correct improperly capitalized acquisition costs.

In fiscal year 2012, we also found that SEC's annual physical inventory count was not effectively performed and did not ensure that all capitalized assets were properly reflected in SEC's financial statements. Specifically, the annual inventory did not include procedures to ensure that all capitalized assets were accounted for or that actions taken in response to inventory results were in accordance with SEC policy. Further, SEC's annual inventory reconciliation was not properly designed to identify or evaluate the financial statement impact of missing, obsolete, surplused, and additional capitalizable assets identified during the annual inventory.

Also in fiscal year 2012, we found deficiencies in SEC's ongoing oversight and monitoring controls over property and equipment transactions. Specifically, we noted that SEC's required monthly monitoring procedures over leasehold improvements and software development project entries for recording fixed assets, completions, and disposals were not performed for the 3 months ended June 30, 2012. Further, SEC's procedures did not provide for monitoring depreciation expense or the accumulated depreciation calculated and recorded in the general ledger by its shared service provider on a timely basis. In light of SEC's migration of its core financial system to a shared service provider during the third quarter of fiscal year 2012, such monitoring controls are key to ensuring that the shared service provider's financial reporting of SEC's transactions is complete, accurate, and timely. SEC enhanced monitoring procedures over leasehold improvements and software development projects and established an annual monitoring process over the depreciation calculation in September 2012. SEC also corrected most of the substantive errors we identified through our interim and year-end testing. The remaining uncorrected errors did not materially affect the balances reported for property and equipment or the corresponding depreciation expense amounts in SEC's financial statements for fiscal year 2012. However, until SEC fully implements its enhanced monitoring control procedures, SEC will continue to be at risk of misstatements related to its property and equipment transactions. Consequently,

[11] In this analysis, SEC captures the effect in the current fiscal year of errors from the previous year. Specifically, SEC identifies transactions that were recorded in the current fiscal year but should have been recorded in a prior fiscal year. SEC tracks this information to assess the significance of such misstatements and uses this analysis to determine if prior year financial statements require restatement.

they collectively represent a significant deficiency in SEC's internal control over property and equipment during fiscal year 2012.

Compliance with Laws and Regulations

Our tests of SEC's compliance with selected provisions of laws and regulations for the agency as a whole and IPF for fiscal year 2012 disclosed no instances of noncompliance that would be reportable under U.S. generally accepted government auditing standards. The objective of our audit was not to provide an opinion on overall compliance with laws and regulations. Accordingly, we do not express such an opinion.

Required Supplementary Information

U.S. generally accepted accounting principles require that required supplementary information (RSI) be presented to supplement the financial statements.[12] This information, although not a part of the financial statements, is required by the Federal Accounting Standards Advisory Board (FASAB), who considers it to be an essential part of financial reporting for placing the financial statements in appropriate operational, economic, or historical context. We did not audit and we do not express an opinion or provide any assurance on the RSI because the limited procedures we applied do not provide sufficient evidence to express an opinion or provide any assurance.

Other Information

SEC's other information[13] contains a wide range of information, some of which is not directly related to the financial statements. This information is presented for purposes of additional analysis and is not a required part of the financial statements or RSI. Our audit was conducted for the purpose of forming an opinion on SEC's and IPF's financial statements. We did not audit and do not express an opinion or provide any assurance on the other information.

Objectives, Scope, and Methodology

SEC management is responsible for (1) preparing the financial statements of the agency and IPF in conformity with U.S. generally accepted accounting principles; (2) preparing, measuring, and presenting the RSI in accordance with the prescribed guidelines in U.S. generally accepted accounting principles; (3) preparing and

[12]RSI comprises Management's Discussion and Analysis and the Combined Statement of Budgetary Resources that are included with the financial statements.
[13]Other information comprises information included with the financial statements, other than RSI and the auditor's report.

presenting other information included in documents containing the audited financial statements and auditor's report, and ensuring the consistency of that information with the audited financial statements and the RSI; (4) establishing and maintaining effective internal control over financial reporting for both the agency as a whole and IPF and evaluating its effectiveness; and (5) complying with laws and regulations applicable to both the agency and IPF. SEC management evaluated the effectiveness of SEC's internal control over financial reporting as of September 30, 2012, based on the criteria established under FMFIA. Under the Dodd-Frank Act, SEC is also responsible for attesting to the effectiveness of its internal control during the fiscal year.[14] SEC management's assertion is included in its Management's Discussion and Analysis included with this report. We are responsible for planning and performing the audits of SEC and IPF to obtain reasonable assurance and provide our opinions about whether (1) the financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, and (2) SEC management maintained, in all material respects, effective internal control over financial reporting for the agency as a whole and IPF as of September 30, 2012. We are also responsible for (1) testing compliance with selected provisions of laws and regulations that have a direct and material effect on the financial statements of SEC and IPF and (2) applying certain limited procedures to the RSI and other information included with the financial statements. Further, under the Dodd-Frank Act, we are responsible for attesting to and reporting on SEC's assessment of its internal control over financial reporting.[15]

In order to fulfill these responsibilities, we

- examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- assessed the accounting principles used and significant estimates made by SEC management;
- evaluated the overall presentation of the financial statements;
- obtained an understanding of SEC's and IPF's operations, including SEC's internal control over financial reporting for both the agency as a whole and IPF;
- considered SEC's process for evaluating and reporting on internal control over financial reporting based on criteria established under FMFIA;
- assessed the risk of (1) material misstatement in the financial statements and (2) material weakness in its internal control over financial reporting;
- evaluated the design and operating effectiveness of SEC's internal control over financial reporting based on the assessed risk;
- tested relevant internal control over SEC's financial reporting;
- evaluated SEC's assessment of its internal control over financial reporting;

[14]Dodd-Frank Act, Pub. L. No. 111-203, § 963(a), 124 Stat. 1376, 1910 (2010), *codified at* 15 U.S.C. § 78d-8(a).
[15]15 U.S.C. § 78d-8(b)(2).

- tested compliance with selected provisions of laws and regulations, including the Securities Exchange Act of 1934, as amended; the Securities Act of 1933, as amended; the Antideficiency Act, as amended; laws governing the pay and allowance system for SEC employees; the Debt Collection Improvement Act of 1996; the Prompt Payment Act, as amended; the Federal Employees' Retirement System Act of 1986; Full-Year Continuing Appropriations Act, 2011, which incorporates, by reference, certain provisions of the Financial Services and General Government Appropriations Act, 2010; and the Dodd-Frank Wall Street Reform and Consumer Protection Act;
- conducted inquiries of management about the methods of preparing the RSI and compared this information for consistency with management's responses to the auditor's inquiries, the financial statements, and other knowledge we obtained during the audit of the financial statements, in order to report omissions or material departures from FASAB guidelines, if any, identified by these limited procedures;
- read the other information included with the financial statements in order to identify material inconsistencies, if any, with the audited financial statements; and
- performed such other procedures as we considered necessary in the circumstances.

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, the objectives of which are to provide reasonable assurance that (1) transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in conformity with U.S. generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition and (2) transactions are executed in accordance with the laws governing the use of budget authority and other laws and regulations that could have a direct and material effect on the financial statements.

We did not evaluate all internal control relevant to operating objectives as broadly established under FMFIA, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to testing controls over financial reporting. Our internal control testing was for the purpose of expressing an opinion on the effectiveness of internal control over financial reporting and may not be sufficient for other purposes. Consequently, our audit may not identify all deficiencies in internal control over financial reporting that are less severe than a material weakness. Because of inherent limitations, internal control may not prevent or detect and correct misstatements caused by error or fraud, losses, or noncompliance. We also caution that projecting any evaluation of effectiveness to future periods is subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

We did not test compliance with all laws and regulations applicable to SEC or IPF. We limited our tests of compliance to selected provisions of laws and regulations that have a direct and material effect on SEC's and IPF's financial statements for the fiscal year ended September 30, 2012. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes.

We performed our audit in accordance with U.S. generally accepted government auditing standards. We believe our audit provides a reasonable basis for our opinions and other conclusions.

Agency Comments and Our Evaluation

In commenting on a draft of this report, SEC's Chairman expressed her pleasure that GAO found that SEC had successfully remediated three of the significant deficiencies identified in 2011, and attributed this success to the hard work and dedication of staff in SEC's Office of the Chief Operating Officer, Office of Financial Management, and Office of Information Technology. The Chairman stated that SEC will continue to work toward remediating the two remaining significant deficiencies in the areas of budgetary resources and property and equipment. The Chairman added that SEC will further work to optimize its processes under its new shared service provider environment and look for further opportunities to gain efficiencies in those processes. The complete text of SEC's comments is reprinted in enclosure I.

James R. Dalkin
Director
Financial Management and Assurance

November 14, 2012

Enclosure I: Management's Response to Audit Opinion

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

November 13, 2012

Mr. James R. Dalkin
Director
Financial Management and Assurance
United States Government Accountability Office
441 G Street, N.W.
Washington, DC 20548

Dear Mr. Dalkin:

Thank you for the opportunity to review and comment on the audit report of the Government Accountability Office (GAO). I am pleased that the GAO's FY 2012 audit found that the SEC's financial statements and notes were presented fairly, in all material respects, and in conformity with U.S. generally accepted accounting principles.

Furthermore, I am pleased the GAO found that the SEC has successfully remediated three of the significant deficiencies identified in 2011. This accomplishment was the result of the hard work and dedication of staff in the SEC's Office of the Chief Operating Officer, Office of Financial Management, and Office of Information Technology. These efforts were part of the agency's long-term initiative to bolster its internal controls over financial reporting and put these controls on a more sustainable footing. Another key project under this initiative was the SEC's successful migration to a Federal Shared Service Provider (FSSP), engaging with the Department of Transportation's Enterprise Service Center (ESC). Through this system change, which was completed in FY 2012, the SEC aimed to improve system functionality, automate some manual processes, and further enhance financial management and reporting.

While we have made significant strides in the SEC's multi-year path to build a strong, sustainable internal control posture, the agency will continue to dedicate its energies towards remediating our two remaining significant deficiencies, in the areas of budgetary resources and property and equipment. In particular, the SEC will focus on tightening controls over deobligations from completed contracts, strengthening the monitoring and recording of obligations, and improving our program to properly record and track physical assets. Further, the SEC will work to optimize its processes under the new FSSP environment, and look for further opportunities to gain efficiencies in those processes.

I very much appreciate the professional manner in which you and your team conducted the audit for FY 2012. I look forward to continuing our productive dialogue in the coming months on the SEC's efforts to address the areas noted in your report. If you have any questions, please feel free to contact me.

Sincerely,

Mary L. Schapiro
Chairman

SEC Financial Statements

Financial Statements

U.S. SECURITIES AND EXCHANGE COMMISSION

Balance Sheets

As of September 30, 2012 and 2011

(DOLLARS IN THOUSANDS)	FY 2012	FY 2011
ASSETS (Note 2):		
Intragovernmental:		
Fund Balance with Treasury (Note 3)	$ 7,443,432	$ 6,995,610
Investments, Net (Note 5)	973,916	1,202,525
Accounts Receivable (Note 6)	—	20
Advances and Prepayments	7,824	7,172
Total Intragovernmental	8,425,172	8,205,327
Cash and Other Monetary Assets (Note 4)	1,066	—
Accounts Receivable, Net (Note 6)	236,691	214,026
Advances and Prepayments	235	3,656
Property and Equipment, Net (Note 7)	97,570	93,939
Total Assets	$ 8,760,734	$ 8,516,948
LIABILITIES (Note 8):		
Intragovernmental:		
Accounts Payable	$ 8,829	$ 8,049
Employee Benefits	5,184	2,877
Unfunded FECA and Unemployment Liability	1,441	1,770
Custodial Liability	62,497	51,745
Liability for Non-Entity Assets	2,457	134
Total Intragovernmental	80,408	64,575
Accounts Payable	39,474	52,768
Actuarial FECA Liability	8,050	7,805
Accrued Payroll and Benefits	13,765	18,395
Accrued Leave	48,531	45,472
Registrant Deposits	33,689	46,622
Liability for Disgorgement and Penalties (Note 16)	932,763	862,976
Other Accrued Liabilities (Note 8)	5,765	7,212
Total Liabilities	1,162,445	1,105,825
Commitments and Contingencies (Note 10)		
NET POSITION:		
Unexpended Appropriations – Other Funds	764	735
Cumulative Results of Operations – Earmarked Funds (Note 11)	7,596,330	7,409,186
Cumulative Results of Operations – Other Funds	1,195	1,202
Total Net Position	$ 7,598,289	$ 7,411,123
Total Liabilities and Net Position	$ 8,760,734	$ 8,516,948

The accompanying notes are an integral part of these financial statements.

U.S. SECURITIES AND EXCHANGE COMMISSION

Statements of Net Cost

For the years ended September 30, 2012 and 2011

(DOLLARS IN THOUSANDS)	**FY 2012**	**FY 2011**
PROGRAM COSTS (Note 12):		
Enforcement	$ 400,574	$ 391,183
Compliance Inspections and Examinations	235,737	239,435
Corporation Finance	137,441	131,660
Trading and Markets	67,936	62,176
Investment Management	48,238	47,240
Risk, Strategy and Financial Innovation	20,296	20,080
General Counsel	40,951	41,357
Other Program Offices	48,791	45,122
Agency Direction and Administrative Support	190,314	163,357
Inspector General	7,238	6,528
Total Program Costs	1,197,516	1,148,138
Less: Earned Revenue Not Attributed to Programs (Note 12)	1,647,859	1,643,730
Net (Income) Cost from Operations (Note 15)	$ (450,343)	$ (495,592)

The accompanying notes are an integral part of these financial statements.

U.S. SECURITIES AND EXCHANGE COMMISSION

Statements of Changes in Net Position

For the years ended September 30, 2012 and 2011

	FY 2012		
(DOLLARS IN THOUSANDS)	Earmarked Funds	All Other Funds	Consolidated Total
CUMULATIVE RESULTS OF OPERATIONS:			
Beginning Balances	$ 7,409,186	$ 1,202	$ 7,410,388
Budgetary Financing Sources:			
Appropriations Used	32,601	(29)	32,572
Non-Exchange Revenue	757	—	757
Other Financing Sources:			
Transfers In/Out Without Reimbursement	(784)	784	—
Imputed Financing (Note 13)	30,588	—	30,588
Transferred to the General Fund	—	(327,123)	(327,123)
Total Financing Sources	63,162	(326,368)	(263,206)
Net Income (Cost) from Operations	123,982	326,361	450,343
Net Change	187,144	(7)	187,137
Cumulative Results of Operations (Note 11)	7,596,330	1,195	7,597,525
UNEXPENDED APPROPRIATIONS:			
Beginning Balances	—	735	735
Budgetary Financing Sources:			
Appropriations Received	32,601	—	32,601
Appropriations Used	(32,601)	29	(32,572)
Total Budgetary Financing Sources	—	29	29
Total Unexpended Appropriations	—	764	764
Net Position, End of Period	$ 7,596,330	$ 1,959	$ 7,598,289

	FY 2011		
(DOLLARS IN THOUSANDS)	Earmarked Funds	All Other Funds	Consolidated Total
CUMULATIVE RESULTS OF OPERATIONS:			
Beginning Balances	$ 6,878,132	$ 603	$ 6,878,735
Budgetary Financing Sources:			
Appropriations Used	—	1,014	1,014
Non-Exchange Revenue	990	—	990
Other Financing Sources:			
Transfers In/Out Without Reimbursement	—	—	—
Imputed Financing (Note 13)	34,380	—	34,380
Transferred to the General Fund	—	(323)	(323)
Total Financing Sources	35,370	691	36,061
Net Income (Cost) from Operations	495,684	(92)	495,592
Net Change	531,054	599	531,653
Cumulative Results of Operations (Note 11)	7,409,186	1,202	7,410,388
UNEXPENDED APPROPRIATIONS:			
Beginning Balances	—	1,749	1,749
Budgetary Financing Sources:			
Appropriations Received	—	—	—
Appropriations Used	—	(1,014)	(1,014)
Total Budgetary Financing Sources	—	(1,014)	(1,014)
Total Unexpended Appropriations	—	735	735
Net Position, End of Period	$ 7,409,186	$ 1,937	$ 7,411,123

The accompanying notes are an integral part of these financial statements.

U.S. SECURITIES AND EXCHANGE COMMISSION

Statements of Budgetary Resources

For the years ended September 30, 2012 and 2011

(DOLLARS IN THOUSANDS)	FY 2012	FY 2011
BUDGETARY RESOURCES:		
Unobligated Balance, Brought Forward, October 1	$ (279,929)	$ 489,349
Recoveries of Prior Year Unpaid Obligations	26,688	38,945
Downward Adjustments of Prior Year Unfunded Lease Obligations (Note 14.C)	141,933	—
Unobligated Balance from Prior Year Budget Authority, Net	(111,308)	528,294
Appropriations (Discretionary and Mandatory)	58,226	(847)
Spending Authority from Offsetting Collections (Discretionary and Mandatory)	1,289,139	1,186,084
Total Budgetary Resources	$ 1,236,057	$ 1,713,531
STATUS OF BUDGETARY RESOURCES:		
Obligations Incurred (Note 14):		
Direct and Reimbursable	$ 1,192,385	$ 1,215,532
Change in Legal Interpretation for Lease Obligations	—	777,928
Subtotal	1,192,385	1,993,460
Unobligated Balance, End of Year:		
Apportioned	522,993	459,248
Exempt from Apportionment	12,642	—
Unapportioned	(491,963)	(739,177)
Total Unobligated Balance, End of Year	43,672	(279,929)
Total Budgetary Resources	$ 1,236,057	$ 1,713,531
CHANGE IN OBLIGATED BALANCE:		
Unpaid Obligations, Brought Forward, October 1 (Gross)	$ 1,110,634	$ 317,772
Uncollected Customer Payments from Federal Sources, Brought Forward, October 1	(47)	(25)
Obligated Balance, Start of Year (Net)	1,110,587	317,747
Obligations Incurred	1,192,385	1,993,460
Outlays (Gross)	(1,179,800)	(1,161,653)
Change in Uncollected Customer Payments from Federal Sources	(142)	(22)
Recoveries of Prior Year Unpaid Obligations	(26,688)	(38,945)
Downward Adjustments of Prior Year Unfunded Lease Obligations (Note 14.C)	(141,933)	—
Total Obligated Balance, End of Year	$ 954,409	$ 1,110,587
Obligated Balance, End of Year		
Unpaid Obligations, End of Year (Gross)	$ 954,598	$ 1,110,634
Uncollected Customer Payments from Federal Sources, End of Year	(189)	(47)
Obligated Balance, End of Year (Net)	$ 954,409	$ 1,110,587
BUDGET AUTHORITY AND OUTLAYS, NET:		
Budget Authority, Gross (Discretionary and Mandatory)	$ 1,347,365	$ 1,185,237
Actual Offsetting Collections (Discretionary and Mandatory)	(1,288,998)	(1,598,067)
Change in Uncollected Customer Payments from Federal Sources (Discretionary and Mandatory)	(142)	(22)
Budget Authority, Net (Discretionary and Mandatory)	$ 58,225	$ (412,852)
Outlays, Gross (Discretionary and Mandatory)	$ 1,179,800	$ 1,161,653
Actual Offsetting Collections (Discretionary and Mandatory)	(1,288,998)	(1,598,067)
Outlays, Net (Discretionary and Mandatory)	(109,198)	(436,414)
Distributed Offsetting Receipts	(1,123)	660
Agency Outlays, Net (Discretionary and Mandatory)	$ (110,321)	$ (435,754)

The accompanying notes are an integral part of these financial statements.

U.S. SECURITIES AND EXCHANGE COMMISSION

Statements of Custodial Activity

For the years ended September 30, 2012 and 2011

(DOLLARS IN THOUSANDS)	FY 2012	FY 2011
REVENUE ACTIVITY:		
Sources of Cash Collections:		
Disgorgement and Penalties	$ 377,645	$ 413,413
Other	1,059	8,109
Total Cash Collections	378,704	421,522
Accrual Adjustments	10,633	9,365
Total Custodial Revenue	389,337	430,887
DISPOSITION OF COLLECTIONS:		
Amounts Transferred to:		
Department of the Treasury	378,704	421,522
Amounts Yet to be Transferred	10,633	9,365
Total Disposition of Collections	389,337	430,887
NET CUSTODIAL ACTIVITY	$ —	$ —

The accompanying notes are an integral part of these financial statements.

Notes to the Financial Statements

U.S. SECURITIES AND EXCHANGE COMMISSION

As of September 30, 2012 and 2011

NOTE 1. Significant Accounting Policies

A. Reporting Entity

The U.S. Securities and Exchange Commission (SEC) is an independent agency of the U.S. Government established pursuant to the Securities Exchange Act of 1934 (Exchange Act), charged with regulating this country's capital markets. The SEC's mission is to protect investors; maintain fair, orderly, and efficient securities markets; and facilitate capital formation. The SEC works with Congress, other executive branch agencies, Self Regulatory Organizations (SROs) (e.g., stock exchanges and the Financial Industry Regulatory Authority (FINRA)), accounting and auditing standards setters, state securities regulators, law enforcement officials, and many other organizations in support of the agency's mission.

The agency's programs protect investors and promote the public interest by fostering and enforcing compliance with the Federal securities laws; establishing an effective regulatory environment; facilitating access to the information investors need to make informed investment decisions; and enhancing the SEC's performance through effective alignment and management of human, information, and financial capital.

The SEC consists of five presidentially-appointed Commissioners, with staggered five-year terms. The SEC is organized into five Divisions and multiple offices. The five divisions are the Division of Enforcement; the Division of Corporation Finance; the Division of Trading and Markets; the Division of Investment Management; and the Division of Risk, Strategy, and Financial Innovation. The offices include the Office of Compliance Inspections and Examinations, the Office of General Counsel, the Office of Investor Education and Advocacy, the Office of the Chief Accountant, the Office of International Affairs, the Office of Administrative Law Judges, the Office of Credit Ratings, the Office of the Investor Advocate, the Office of Municipal Securities, and various supporting services.

The SEC reporting entity includes the Investor Protection Fund (See *Note 1.T, Investor Protection Fund*). In addition to being included in the SEC's financial statements, the Investor Protection Fund's financial statements are also presented separately as stand-alone documents, as required by Exchange Act Section 21F(g)5.

As discussed in *Note 10.A, Commitments: Securities Investor Protection Act*, the SEC reporting entity does not include the Securities Investor Protection Corporation (SIPC).

As discussed in *Note 1.S, Disgorgement and Penalties*, disgorgement funds collected and held by the SEC on behalf of harmed investors are part of the SEC reporting entity. However, disgorgement funds held by the U.S. Courts and by non-Federal receivers on behalf of harmed investors are not part of the SEC reporting entity.

B. Basis of Presentation and Accounting

The accompanying financial statements present the financial position, net cost of operations, changes in net position, budgetary resources, and custodial activities of the SEC's core business activities as required by the Accountability of Tax Dollars Act of 2002. The statements may differ from other financial reports submitted pursuant to Office of Management and Budget (OMB) directives for the purpose of monitoring and controlling the use of the SEC budgetary resources, due to differences in applicable accounting and reporting principles discussed in the following paragraphs. The SEC's books and records serve as the source of the information presented in the accompanying financial statements.

The agency classifies assets, liabilities, revenues, and costs in these financial statements according to the type of entity associated with the transactions. Intragovernmental assets and liabilities are those due from or to other Federal entities. Intragovernmental revenues are earned from other Federal entities. Intragovernmental costs are payments or accruals due to other Federal entities.

The SEC's financial statements are prepared in conformity with generally accepted accounting principles (GAAP) for the Federal Government and presented in conformity with OMB Circular A-136, *Financial Reporting Requirements*. The Balance Sheet, Statement of Net Cost and Statement of Changes in Net Position are prepared using the accrual basis of accounting. Accordingly, revenues are recognized when earned and expenses are recognized when incurred without regard to the receipt or payment of cash. These principles differ from budgetary accounting and reporting principles on which the Statement of Budgetary Resources is prepared. The differences relate primarily to the capitalization and depreciation of property and equipment, as well as the recognition of other long-term assets and liabilities. The Statement of Custodial Activity is presented on the modified cash basis of accounting. Cash collections and amounts transferred to Treasury or the Investor Protection Fund are reported on a cash basis. The change in receivables and related payables are reported on an accrual basis.

The SEC presents net cost of operations by program. OMB Circular A-136 defines the term "major program" as describing an agency's mission, strategic goals, functions, activities, services, projects, processes, or any other meaningful grouping. The presentation by program is consistent with the presentation used by the agency in submitting its budget requests.

Certain prior year amounts presented on the Statement of Budgetary Resources and Required Supplementary Information have been reclassified to conform to the current year presentation required by OMB Circular A-136.

C. Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities. These estimates and assumptions include, but are not limited to, the disclosure of contingent liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Estimates are also used in the allocation of costs to the SEC programs presented in the Statement of Net Cost. Actual results may differ from those estimates.

D. Intra- and Inter-Agency Relationships

The SEC is comprised of a single Federal agency with limited intra-entity transactions. The Investor Protection Fund, which was created in FY 2010, can finance the operations of the SEC Office of Inspector General's Employee Suggestion Program and the Office of the Whistleblower on a reimbursable basis. This has given rise to a small amount of intra-entity eliminations of the related revenue and expense transactions between the Investor Protection Fund and the SEC's General Salaries and Expenses Fund.

E. Fund Accounting Structure

The SEC, in common with other Federal agencies, utilizes various Treasury Appropriation Fund Symbols (Funds), to recognize and track appropriation authority provided by Congress, collections from the public and other financial activity. These funds are described below:

(1) **Earmarked Funds:**

- **Salaries and Expenses:** Earned revenues from securities transaction fees from SROs are deposited into Fund X0100, *Salaries and Expenses, Securities and Exchange Commission*. These collections are earmarked for carrying out the SEC's mission, functions, and day to day operations and may be used in accordance with spending limits established by Congress. Collections in excess of Congressional spending limits are unavailable by law and reported as Non-Budgetary Fund Balance with Treasury (See *Note 3, Fund Balance with Treasury*). In this context, "earmarked" indicates that these collections are set aside by Congress for the purpose stated.

  Prior to FY 2012, earned revenues from securities registration, tender offer, merger, and other fees from registrants were also deposited into the Salaries and Expenses account (Fund X0100) and were earmarked for the SEC's activities. Beginning in FY 2012, these amounts are either deposited into the SEC's Reserve Fund (X5566) or the U.S. Treasury General Fund pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) refer to *Note 1.J, Accounts Receivable and Allowance for Uncollectible Accounts, Non-Entity Accounts Receivable*.

- **Investor Protection Fund:** The Investor Protection Fund is an earmarked fund that provides dedicated funding for the whistleblower awards as required by the

Dodd-Frank Act. Persons may receive award payments from the Fund if they provide original information to the SEC that results in a successful enforcement action and other conditions are met. In addition, the Fund can be used to finance the operations of the Office of the Whistleblower and the SEC Office of Inspector General's Employee Suggestion Program for the receipt of suggestions for improvements in work efficiency and effectiveness, and allegations of misconduct or mismanagement within the SEC. This activity is recognized in Fund X5567, *Monetary Sanctions and Interest, Investor Protection Fund, Securities and Exchange Commission (Investor Protection Fund)*. See *Note 1.T, Investor Protection Fund*.

- **Reserve Fund:** Effective October 1, 2011, a portion of SEC registration fee collections up to $50 million in any one fiscal year may be deposited in the Reserve Fund, the balance of which cannot exceed $100 million. The Reserve Fund is an earmarked fund that may be used by the SEC to obligate up to $100 million in one fiscal year as the SEC determines necessary to carry out its functions. Although amounts deposited in the Reserve Fund are not subject to apportionment, the SEC must notify Congress when funds are obligated. This $100 million cap may be limited by the balance in the fund and Congressional action. Pursuant to the SEC's FY 2012 Appropriations Act, $25 million was temporarily rescinded, leaving $25 million available in FY 2012. This activity is recognized in Fund X5566, *Securities and Exchange Commission Reserve Fund*.

(2) **Miscellaneous Receipt Accounts:**

- The Miscellaneous Receipt Accounts hold non-entity receipts and accounts receivable from custodial activities that the SEC cannot deposit into funds under its control. These accounts include registration fee collections in excess of amounts deposited into the Reserve Fund, receipts pursuant to certain SEC enforcement actions and other small collections that will be sent to the U.S. Treasury General Fund upon collection. This activity is recognized in Fund 0850.150, *Registration, Filing, and Transaction Fees, Securities and Exchange Commission*; Fund 1060, *Forfeitures of Unclaimed Money and Property*; Fund 1099, *Fines, Penalties, and Forfeitures, Not Otherwise Classified*; Fund 1435, *General Fund Proprietary Interest, Not Otherwise Classified*; and Fund 3220, *General Fund Proprietary Receipts, Not Otherwise Classified*.

(3) **Deposit Funds:**

- The Deposit Funds hold disgorgement, penalties, and interest collected and held on behalf of harmed investors, registrant monies held temporarily until earned by the SEC, and collections awaiting disposition or reclassification. This activity is recognized in Fund X6561, *Unearned Fees, Securities and Exchange Commission* and Fund X6563, *Disgorgement and Penalty Amounts Held for Investors, Securities and Exchange Commission.*

The SEC's lending and borrowing authority is limited to authority to borrow funds from Treasury and loan funds to the Securities and Investor Protection Corporation, as discussed in *Note 10, Commitments and Contingencies*. The SEC has custodial responsibilities, as disclosed in *Note 1.M, Liabilities*.

F. Earmarked Funds

Earmarked funds are financed by specifically identified revenues, often supplemented by other financing sources, which remain available over time. The SEC collects specifically identified revenues and is required to use those revenues for designated activities, benefits or purposes and to account for them separately from the Government's general revenues. As described in *Note 1.E, Fund Accounting Structure*, the SEC's earmarked funds are deposited into Fund X0100, *Salaries and Expenses*; Fund X5567, *Investor Protection Fund*; and Fund X5566, *Reserve Fund*.

Statement of Federal Financial Accounting Standards (SFFAS) 43, *Funds from Dedicated Collections: Amending Statement of Federal Financial Accounting Standards 27, Identifying and Reporting Earmarked Funds,* was issued in June 2012 and becomes effective in FY 2013. Other than a change in terminology from "earmarked funds" to "dedicated collections," this statement is not expected to have a significant impact on SEC accounting and reporting. The change in terminology will be reflected in FY 2013 financial reports as early adoption is not permitted.

G. Entity and Non-Entity Assets

Entity assets are assets that the SEC may use in its operations.

Non-entity assets are assets that the SEC holds on behalf of another Federal agency or a third party and are not available for the agency's use. The SEC's non-entity assets include the following: (a) disgorgement, penalties, and interest collected and held or invested by the SEC; (b) disgorgement, penalties, and interest receivable; (c) excess filing fees remitted by registrants (registrant deposits); (d) accounts receivable from filing fees (beginning in FY 2012), and (e) other miscellaneous receivables.

H. Fund Balance with Treasury

Fund Balance with Treasury (FBWT) reflects amounts the SEC holds in the U.S. Treasury that have not been invested in Federal securities. The SEC's FBWT consist of several components.

(1) The aggregate amount of funds in the SEC's general fund accounts with Treasury that the SEC is authorized to use to make expenditures and pay liabilities;

(2) Securities transaction fees in excess of appropriated amounts;

(3) Filing fees in excess of appropriated amounts from fiscal years 2011 and prior;

(4) Funds held in the Investor Protection Fund;

(5) Funds held in the Reserve Fund;

(6) Registrant deposits held pending submission of a filing or return to the registrant; and

(7) Disgorgement funds held on behalf of harmed investors.

The SEC conducts all of its banking activity in accordance with directives issued by the U.S. Department of the Treasury's Financial Management Service.

I. Investments

The SEC has the authority to invest disgorgement funds in Treasury securities including civil penalties collected under the "Fair Fund" provision of the Sarbanes-Oxley Act of 2002. As the funds are collected, the SEC holds them in a deposit fund account and may invest them in overnight and short-term market-based Treasury bills through the Bureau of the Public Debt. The SEC adds interest earned to the funds, and these funds are subject to taxation under Treasury Regulation Section 1.468B-2.

The SEC also has authority to invest amounts in the Investor Protection Fund in overnight and short-term market-based Treasury bills through the Bureau of the Public Debt. The interest earned on the investments is a component of the balance of the Fund and available to be used for expenses of the Investor Protection Fund.

Additional information regarding SEC investments is provided in *Note 5, Investments*.

J. Accounts Receivable and Allowance for Uncollectible Accounts

SEC's entity and non-entity accounts receivable consist primarily of amounts due from the public. Entity accounts receivable are amounts that the SEC may retain upon collection. Non-entity accounts receivable are amounts that the SEC will forward to another Federal agency or to the public upon collection.

Entity Accounts Receivable

The bulk of SEC entity accounts receivable arise from securities transaction fees. In addition, the SEC has small amounts of activity arising from the sale of goods or services provided by the SEC to other Federal agencies; reimbursement of employee travel by outside organizations; and employee-related debt. Entity accounts receivable balances are normally small at year-end due to the timing and payment requirements relative to the largest categories of accounts receivable activity. Specifically, securities transaction fees are payable to the SEC twice a year: in March for the period September through December, and in September for the period January through August. Accordingly, the year-end accounts receivable accrual generally represents fees payable to the SEC for one month of securities transaction fee activity (September).

Non-entity Accounts Receivable

Non-entity accounts receivable arise mainly from amounts assessed against violators of securities laws, including disgorgement of illegal gains, civil penalties, and related assessed interest. The SEC is responsible for collection, and recognizes a receivable, when an order of the Commission or a Federal court directs payment to the SEC or the U.S. Treasury.

Interest recognized by the SEC on non-entity accounts receivable includes prejudgment interest specified by the court or administrative order as well as post-judgment interest on collectible accounts. The SEC does not recognize interest revenue on accounts considered to be uncollectible.

The SEC is also party to court orders directing violators of Federal securities laws to pay amounts assessed to a Federal court or to a non-Federal receiver acting on behalf of harmed investors. These orders are not recognized as accounts receivable by the SEC because the debts are payable to, and collected by, another party.

Prior to FY 2012, filing fee collections were available to the SEC for use in its operations up to spending limits established by Congress and the associated accounts receivable were classified as entity assets. Beginning in FY 2012, filing fee collections in excess of those deposited into the SEC's Reserve Fund are not available for the SEC's operations and are transferred to the U.S. Treasury General Fund. Accounts receivable amounts arising from filing fees in excess of those deposited into the Reserve Fund are non-entity and are held on behalf of the U.S. Treasury.

Allowance for Uncollectible Amounts

The SEC calculates the allowance for uncollectible amounts and the related provision for estimated losses for filing fees and other accounts receivable using an analysis of historical collection data. No allowance for uncollectible amounts or related provision for estimated losses has been established for securities transaction fees payable by SROs, as these amounts are fully collectible based on historical experience.

In FY 2012, the SEC changed its methodology for calculating the allowance for loss on its disgorgement and penalty accounts receivable. Previously, the SEC used a three-tiered methodology, in which the first tier involved making an individual collection assessment of the cases constituting the top 90 percent of the disgorgement and penalty accounts receivable portfolio. The first tier now involves making an individual collection assessment of cases that represent at least 65 percent of the portfolio. The second and third tiers are composed of the remaining cases that are equal to or less than 30 days old and over 30 days old, respectively. For the second and third tiers, the SEC applies an allowance rate based on historical collection data analysis.

The SEC writes off receivables aged two or more years by removing the debt amounts from the gross accounts receivable and any related allowance for uncollectible accounts.

K. Other Assets

Payments made in advance of the receipt of goods and services are recorded as advances or prepayments and recognized as expenses when the related goods and services are received. SEC's amortization threshold for non-Federal advances and prepayments was changed from $50 thousand to $2 million during FY 2012.

L. Property and Equipment, Net

The SEC's property and equipment consists of software, general-purpose equipment used by the agency, capital improvements made to buildings leased by the SEC for office space, and, when applicable, internal-use software development costs for projects in development. The SEC reports property and equipment purchases and additions at historical cost. The agency expenses property and equipment acquisitions that do not meet the capitalization criteria as well as normal repairs and maintenance.

The SEC depreciates property and equipment over the estimated useful lives using the straight-line method of depreciation. The agency removes property and equipment from its asset accounts in the period of disposal, retirement, or removal from service. The SEC recognizes the difference between the book value and the proceeds as a gain or loss in the period that the asset is removed.

M. Liabilities

The SEC recognizes liabilities for probable future outflows or other sacrifices of resources as a result of events that have occurred as of the Balance Sheet date. The SEC's liabilities consist of routine operating accounts payable, accrued payroll and benefits, registrant deposit accounts that have not been returned to registrants, liabilities for disgorgement and penalties, legal liabilities, and liabilities for amounts collected or receivable on behalf of Treasury.

Enforcement Related Liabilities

A liability for disgorgement and penalties arises when an order is issued for the SEC to collect disgorgement, penalties, and interest from securities law violators. When the Commission or court issues such an order, the SEC establishes an accounts receivable due to the SEC offset by a liability. The presentation of this liability on the Balance Sheet is dependent upon several factors. If the court or Commission order indicates that collections are to be retained by the Federal Government, either by transfer to the U.S. Treasury General Fund or to the Investor Protection Fund, the liabilities are classified as custodial (that is, collected on behalf of the Government) and intragovernmental. If the order indicates that the funds are eligible for distribution to harmed investors, the SEC will recognize a Governmental liability (that is, a liability of the Government to make a payment to the public). This liability is not presented as a custodial liability. The SEC does not record liabilities on its financial statements for disgorgement and penalty amounts that another Government entity such as a court, or a non-governmental entity, such as a receiver, has collected or will collect.

Prior to the enactment of the Dodd-Frank Act, all collections not distributed to harmed investors were transferred to the U.S. Treasury General Fund. After the enactment of the Dodd-Frank Act, collections not distributed to harmed investors may be transferred to either the Investor Protection Fund or the U.S. Treasury General Fund. Collections not distributed to harmed investors are transferred to the Investor Protection Fund if the Fund's balance does not exceed $300 million at the time of collection. Refer to *Note 16, Disgorgement and Penalties* for additional information.

Liability Classification

The SEC recognizes liabilities covered by three types of resources: realized budgetary resources, unrealized budgetary resources that become available without further Congressional action, and amounts that do not require the use of current budgetary resources. Realized budgetary resources include obligated balances that fund existing liabilities and unobligated balances as of the relevant Balance Sheet dates. Unrealized budgetary resources represent fee collections in excess of amounts appropriated for current fiscal year spending. The SEC uses these budgetary resources to cover liabilities when appropriation language makes these unrealized budgetary resources available in the fiscal year without further Congressional action. Amounts that do not require the use of budgetary resources include liabilities for custodial collections, which are covered by amounts collected and receivables that the SEC collects on behalf of Treasury or other Federal entities; custodial collections do not represent budgetary resources to the SEC.

The SEC also recognizes liabilities not covered by budgetary resources. Budgetary and financial statement reporting requirements sometimes differ on the timing for the required recognition of an expense. For example, in the financial statements, annual leave expense must be accrued in the reporting period when the annual leave is earned. However, in the budget, annual leave is required to be recognized and funded in the fiscal year when the annual leave is either used or paid out to a separating employee, not when recognized in the financial statements. As a result of this timing difference, accrued annual leave liability is classified as a liability "not covered by budgetary resources" as of the financial statement date.

N. Employee Retirement Systems and Benefits

The SEC's employees may participate in either the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS), depending on when they started working for the Federal Government. FERS and Social Security automatically cover most employees hired after December 31, 1983. Employees who are rehired after a break in service of more than one year and who had five years of Federal civilian service prior to 1987 are eligible to participate in the CSRS offset retirement system or may elect to join FERS.

All employees are eligible to contribute to a Thrift Savings Plan (TSP). For those employees participating in FERS, the TSP is automatically established, and the SEC makes a mandatory 1 percent contribution to this plan. In addition, the SEC matches contributions ranging from 1 to 4 percent for FERS-eligible employees who contribute to their TSP. The SEC contributes a matching amount to the Social Security

Administration under the Federal Insurance Contributions Act, which fully covers FERS participating employees. Employees participating in CSRS do not receive matching contributions to their TSP.

The SEC does not report CSRS, FERS, Federal Employees Health Benefits Program (FEHBP), Federal Employees Group Life Insurance Program (FEGLIP) assets, accumulated plan benefits, or unfunded liabilities applicable to its employees; the U.S. Office of Personnel Management (OPM) reports this information.

O. Injury and Post-employment Compensation

The Federal Employees' Compensation Act (FECA), administered by the U.S. Department of Labor (DOL), provides income and medical cost protection to covered Federal civilian employees harmed on the job or who have contracted an occupational disease, and dependents of employees whose death is attributable to a job-related injury or occupational disease. The DOL bills the SEC annually as claims are paid, and the SEC in turn accrues a liability to recognize the future payments. Payment on these bills is deferred for two years to allow for funding through the budget process. Similarly, employees that the SEC terminates without cause may receive unemployment compensation benefits under the unemployment insurance program also administered by the DOL, which bills each agency quarterly for paid claims.

In addition, the SEC records an estimate for the FECA actuarial liability using the DOL's FECA model. The model considers the average amount of benefit payments incurred by the SEC for the past three fiscal years, multiplied by the medical and compensation liability to benefits paid (LBP) ratio for the whole FECA program.

P. Annual, Sick, and Other Leave

The SEC accrues annual leave and compensatory time as earned and reduces the accrual when leave is taken. The balances in the accrued leave accounts reflect current leave balances and pay rates. No portion of this liability has been obligated. Future financing sources provide funding to the extent that current or prior year funding is not available to pay for leave earned but not taken. The SEC expenses sick leave and other types of non-vested leave as used.

Q. Revenue and Other Financing Sources

The SEC's revenue and financing sources include exchange revenues, which are generated from transactions in which both parties give and receive value, and non-exchange revenues, which arise from the Government's ability to demand payment.

Exchange Revenue

The SEC's exchange revenue consists primarily of collections of securities transaction fees from SROs and of securities registration, tender offer, merger, and other fees from registrants. The fee rates are calculated by the SEC's Division of Risk, Strategy, and Financial Innovation and established by the SEC in accordance with Federal law and are applied to volumes of activity reported by SROs or to filings submitted by registrants. Fees are recognized as exchange revenue on the effective date of transaction or filing. These fee collections are the primary source of the SEC's funding and may be used up to limits established by Congress. See *Note 1.E, Fund Accounting Structure*.

The SEC recognizes amounts remitted by registrants in advance of the transaction or filing date as a liability until earned by the SEC or returned to the registrant. Federal regulation requires the return of registrant deposits when an account is dormant for three years.

Filing Fee Offsets

The Securities Act of 1933 and the Exchange Act do not permit refunds to registrants for securities that remain unsold after the completion, termination, or withdrawal of an offering. However, Code of Federal Regulations (CFR) Title 17 Chapter II, Part 230, Section 457(p) permits filers to offset a fee paid (filing fee offset) for a subsequent registration statement (offering) filed within five years of the initial filing date of the earlier registration statement. The total aggregate dollar amount of the filing fee associated with the unsold securities may be offset against the total filing fee due on the subsequent offering. Unused filing fee offsets are not a liability to the SEC because registrants cannot obtain refunds of fees or additional services in relation to securities that remain unsold. However, filing fee offsets may reduce revenue earned in future accounting periods.

Non-exchange Revenue

The SEC's non-exchange revenue mainly consists of amounts collected from violators of securities laws as a result of enforcement proceedings. These amounts may take the form of disgorgement of illegal gains, civil penalties, and related interest. Amounts collected may be paid to injured investors, transferred to the Investor Protection Fund, or transferred to the U.S. Treasury General Fund, based on established policy and regulation.

All non-exchange revenue expected to be forwarded to either the U.S. Treasury General Fund or Investor Protection Fund is recognized on the Statement of Custodial Activity. The Investor Protection Fund recognizes non-exchange revenue on the Statement of Changes in Net Position when funds are transferred into the Investor Protection Fund. The result is that, in accordance with Federal accounting standards, the entire amount of custodial activity is presented on the Statement of Custodial Activity to document the movement of funds, and the portion retained by the SEC is recognized as SEC activity.

The SEC does not recognize amounts collected and held by another government entity, such as a court registry, or a non-government entity, such as a receiver.

R. Budgets and Budgetary Accounting

The SEC is subject to certain restrictions on the use of securities transaction fees. The SEC deposits securities transaction fee revenue in a designated account at Treasury. However, the SEC may use funds from this account only as authorized by Congress and made available by OMB apportionment, upon issuance of a Treasury warrant. Revenue collected in excess of appropriated amounts is restricted from use by the SEC. Funds appropriated that the SEC does not use in a given fiscal year are maintained in a designated account for use in future periods in accordance with the requirements of the SEC's appropriation. Beginning in FY 2012, collections arising from securities registration, tender offer, merger, and other fees from registrants, other than those that are deposited in the Reserve Fund, are no longer available to be used in the operations of the SEC. Refer to *Note 1.E, Fund Accounting Structure.*

Salaries and Expenses

Each fiscal year, the SEC receives Category A apportionments, which are quarterly distributions of budgetary resources made by OMB. The SEC also receives a small amount of Category B funds related to reimbursable activity, which are exempt from quarterly apportionment.

Investor Protection Fund

The Investor Protection Fund is a special fund that has the authority to retain revenues and other financing sources not used in the current period for future use. The Dodd-Frank Act provides that the Fund is available to the SEC without further appropriation or fiscal year limitation for the purpose of paying awards to whistleblowers and funding the activities of the Office of Inspector General's Employee Suggestion Program. However, the SEC is required to request and obtain an annual apportionment from OMB to use these funds. All of the funds are Category B, exempt from quarterly apportionment.

Reserve Fund

The Reserve Fund is a special fund that has the authority to retain certain revenues not used in the current period for future use. The Dodd-Frank Act provides that the Fund is available to the SEC without further appropriation or fiscal year limitation "to carry out the functions of the Commission." Amounts in the Reserve Fund are exempt from apportionment.

S. Disgorgement and Penalties

The SEC maintains non-entity assets related to disgorgements and penalties ordered pursuant to civil injunctive and administrative proceedings. The SEC also recognizes an equal and offsetting liability for these assets as discussed in *Note 1.M, Liabilities*. These non-entity assets consist of disgorgement, penalties, and interest assessed against securities law violators where the Commission, administrative law judge, or in some cases, a court, has determined that the SEC should return such funds to harmed investors or may be transferred to the Investor Protection Fund or the U.S. Treasury General Fund. The SEC does not record on its financial statements any asset amounts that another Government entity such as a court, or a non-governmental entity, such as a receiver, has collected or will collect. Additional details regarding disgorgement and penalties are presented in *Note 11, Earmarked Funds*, and *Note 16, Disgorgement and Penalties*.

T. Investor Protection Fund

The Investor Protection Fund was established through a permanent indefinite appropriation to provide financing for payments to whistleblowers and can be used for the expenses of the Office of the Whistleblower and the SEC Office of Inspector General's Employee Suggestion Program. The Investor Protection Fund is financed by transferring a portion of monetary sanctions collected by the SEC in judicial or administrative actions brought by the SEC under the securities laws that are not added to a disgorgement fund or other funds intended for harmed investors under Section 308 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7246). Sanctions collected by the Commission payable either to the SEC or the U.S. Treasury General Fund will be transferred to the Investor Protection Fund if the balance in that fund is less than $300 million on the day of collection.

The SEC may request the Secretary of the Treasury to invest Investor Protection Fund amounts in Treasury obligations. Refer to *Note 1.I, Investments*, for additional details.

NOTE 2. Entity and Non-Entity Assets

At September 30, 2012, SEC entity and non-entity assets consisted of the following:

(DOLLARS IN THOUSANDS)	Entity	Non-Entity	Total
Intragovernmental:			
Fund Balance with Treasury:			
SEC Funds	$ 7,067,857	$ —	$ 7,067,857
Registrant Deposits	—	33,689	33,689
Disgorgement and Penalties (Note 16)	—	341,886	341,886
Investments, Net:			
Disgorgement and Penalties (Note 16)	—	521,444	521,444
Investor Protection Fund	452,472	—	452,472
Accounts Receivable	—	—	—
Advances and Prepayments	7,824	—	7,824
Total Intragovernmental Assets	7,528,153	897,019	8,425,172
Cash and Other Monetary Assets:			
SEC Funds	8	—	8
Disgorgement and Penalties (Note 16)	—	1,058	1,058
Accounts Receivable, Net:			
SEC Funds	103,312	—	103,312
Disgorgement and Penalties (Note 16)	—	130,616	130,616
Custodial and Other Non-Entity Assets	—	2,763	2,763
Advances and Prepayments	235	—	235
Property and Equipment, Net (Note 7)	97,570	—	97,570
Total Assets	$ 7,729,278	$ 1,031,456	$ 8,760,734

At September 30, 2011, SEC entity and non-entity assets consisted of the following:

(DOLLARS IN THOUSANDS)	Entity	Non-Entity	Total
Intragovernmental:			
Fund Balance with Treasury:			
SEC Funds	$ 6,875,059	$ —	$ 6,875,059
Registrant Deposits	—	46,622	46,622
Disgorgement and Penalties (Note 16)	—	73,929	73,929
Investments, Net:			
Disgorgement and Penalties (Note 16)	—	749,810	749,810
Investor Protection Fund	452,715	—	452,715
Accounts Receivable	20	—	20
Advances and Prepayments	7,172	—	7,172
Total Intragovernmental Assets	7,334,966	870,361	8,205,327
Cash and Other Monetary Assets:			
SEC Funds	—	—	—
Disgorgement and Penalties (Note 16)	—	—	—
Accounts Receivable, Net:			
SEC Funds	122,910	—	122,910
Disgorgement and Penalties (Note 16)	—	90,982	90,982
Custodial and Other Non-Entity Assets	—	134	134
Advances and Prepayments	3,656	—	3,656
Property and Equipment, Net (Note 7)	93,939	—	93,939
Total Assets	$ 7,555,471	$ 961,477	$ 8,516,948

Refer to *Note 1.G, Entity and Non-Entity Assets* for additional details.

NOTE 3. Fund Balance with Treasury

The Fund Balance with Treasury by type of fund and Status of Fund Balance with Treasury as of September 30, 2012 and 2011 consists of the following:

(DOLLARS IN THOUSANDS)	FY 2012	FY 2011
Fund Balances:		
General Funds	$ 7,016,900	$ 6,874,986
Special Funds	50,957	73
Other Funds	375,575	120,551
Total Fund Balance with Treasury	$ 7,443,432	$ 6,995,610
Status of Fund Balance with Treasury:		
Unobligated Balance:		
Available	$ 84,943	$ 8,323
Unavailable	56,249	38,751
Obligated Balance not Yet Disbursed	431,386	332,707
Non-Budgetary Fund Balance with Treasury	6,870,854	6,615,829
Total Fund Balance with Treasury	$ 7,443,432	$ 6,995,610

Special Funds consist of the Investor Protection Fund established in FY 2010 and the Reserve Fund established in FY 2012. Refer to *Note 1.E, Fund Accounting Structure*, for additional information.

Other Funds consist of Fund Balance with Treasury held in deposit funds.

Obligated and unobligated balances reported for the status of Fund Balance with Treasury differ from the amounts reported in the Statement of Budgetary Resources due to the fact that budgetary balances are supported by amounts other than Fund Balance with Treasury. These amounts include Investor Protection Fund investments, uncollected payments from Federal sources, and the impact of the change in legal interpretation for leases (see *Note 14.C, Other Budgetary Disclosures, Change in Legal Interpretation for Lease Obligations*). Pursuant to the SEC's FY 2012 Appropriations Act, $25 million in Reserve Fund collections were temporarily rescinded and are included in the unavailable balance reported for FY 2012. Refer to *Note 1.E, Fund Accounting Structure, Earmarked Funds: Reserve Fund*.

Non-Budgetary Fund Balance with Treasury is comprised of amounts in deposit funds and offsetting collections temporarily precluded from obligation in the SEC's General Salaries and Expenses Fund (X0100). Amounts temporarily precluded from obligation represent offsetting collections in excess of appropriated amounts related to securities transaction fees, as well as filing fees collected in fiscal years 2011 and prior.

There were no significant differences between the Fund Balance reflected in the SEC's financial statements and the balance in the Treasury accounts.

NOTE 4. Cash and Other Monetary Assets

The SEC had a cash balance of $1.1 million as of September 30, 2012. The SEC receives disgorgement and penalties collections throughout the year. Any collections received after the U.S. Treasury Department cut-off for deposit of checks are treated as deposits in transit and recognized as Cash on the Balance Sheet. The SEC did not have a cash balance as of September 30, 2011.

NOTE 5. Investments

The SEC invests funds in overnight and short-term non-marketable market-based Treasury bills. The SEC records the value of its investments in Treasury bills at cost and amortizes any premium or discount on a straight-line basis (S/L) through the maturity date of these securities. Non-marketable market-based Treasury securities are issued by the Bureau of Public Debt to Federal agencies. They are not traded on any securities exchange but mirror the prices of similar Treasury securities trading in the Government securities market.

At September 30, 2012, investments consisted of the following:

(DOLLARS IN THOUSANDS)	Cost	Amortization Method	Amortized (Premium) Discount	Interest Receivable	Investment, Net	Market Value Disclosure
Non-Marketable Market-Based Securities						
Disgorgement and Penalties	$ 520,297	S/L	$ (891)	$ 2,038	$ 521,444	$ 519,526
Investor Protection Fund – Entity	454,119	S/L	(2,875)	1,228	452,472	451,319
Total	$ 974,416		$ (3,766)	$ 3,266	$ 973,916	$ 970,845

At September 30, 2011, investments consisted of the following:

(DOLLARS IN THOUSANDS)	Cost	Amortization Method	Amortized (Premium) Discount	Interest Receivable	Investment, Net	Market Value Disclosure
Non-Marketable Market-Based Securities						
Disgorgement and Penalties	$ 749,705	S/L	$ 105	$ —	$ 749,810	$ 749,848
Investor Protection Fund – Entity	453,799	S/L	(2,314)	1,230	452,715	451,696
Total	$ 1,203,504		$ (2,209)	$ 1,230	$ 1,202,525	$ 1,201,544

Intragovernmental Investments in Treasury Securities

The Federal Government does not set aside assets to pay future benefits or other expenditures associated with the investment by Federal agencies in non-marketable Federal securities. The balances underlying these investments are deposited in the U.S. Treasury, which uses the cash for general Government purposes. Treasury securities are issued to the SEC as evidence of these balances. Treasury securities are an asset of the SEC and a liability of the U.S. Treasury. Because the SEC and the U.S. Treasury are both components of the Government, these assets and liabilities offset each other from the standpoint of the Government as a whole. For this reason, the investments presented by the SEC do not represent an asset or a liability in the U.S. Government-wide financial statements.

Treasury securities provide the SEC with authority to draw upon the U.S. Treasury to make future payments from these accounts. When the SEC requires redemption of these securities to make expenditures, the Government finances those expenditures out of accumulated cash balances, by raising taxes or other receipts, by borrowing from the public or repaying less debt, or by curtailing other expenditures. This is the same manner in which the Government finances all expenditures.

NOTE 6. Accounts Receivable, Net

At September 30, 2012, accounts receivable consisted of the following:

(DOLLARS IN THOUSANDS)	Gross Receivables	Allowance	Net Receivables
Intragovernmental Entity Accounts Receivable:			
Reimbursable Activity	$ —	$ —	$ —
Subtotal Intragovernmental Accounts Receivable	—	—	—
Entity Accounts Receivable:			
Securities Transaction Fees	103,009	—	103,009
Filing Fees	—	—	—
Other	372	69	303
Non-Entity Accounts Receivable:			
Disgorgement and Penalties (Note 16)	1,715,267	1,584,651	130,616
Filing Fees	4,304	1,853	2,451
Other	2,158	1,846	312
Subtotal Non-Intragovernmental Accounts Receivable	1,825,110	1,588,419	236,691
Total Accounts Receivable	$ 1,825,110	$ 1,588,419	$ 236,691

At September 30, 2011, accounts receivable consisted of the following:

(DOLLARS IN THOUSANDS)	Gross Receivables	Allowance	Net Receivables
Intragovernmental Entity Accounts Receivable:			
Reimbursable Activity	$ 20	$ —	$ 20
Subtotal Intragovernmental Accounts Receivable	20	—	20
Entity Accounts Receivable:			
Securities Transaction Fees	121,798	—	121,798
Filing Fees	893	109	784
Other	375	47	328
Non-Entity Accounts Receivable:			
Disgorgement and Penalties (Note 16)	952,711	861,729	90,982
Filing Fees	—	—	—
Other	1,329	1,195	134
Subtotal Non-Intragovernmental Accounts Receivable	1,077,106	863,080	214,026
Total Accounts Receivable	$ 1,077,126	$ 863,080	$ 214,046

Refer to *Note 1.J, Accounts Receivable and Allowance for Uncollectible Accounts* for methods used to estimate allowances. The SEC estimates that accumulated interest on accounts receivable considered to be uncollectible is $1.8 million and $1.2 million, respectively, as of September 30, 2012 and 2011. This estimate does not include interest accrued on debts written off or officially waived. The SEC's estimation methodology was revised in FY 2012. In FY 2011, SEC's estimate included accumulated interest on debts written off, but excluded accumulated interest on debts officially waived.

As of September 30, 2012 and 2011, the balances include disgorgement and penalty accounts receivables, net of allowance, of $62.2 million and $51.7 million, respectively designated as payable to the U.S. Treasury General Fund per court order. As discussed in *Note 1.M, Liabilities*, these receivables, their offsetting liabilities, and the associated revenues, are classified as custodial.

As discussed in *Note 1.J, Accounts Receivable and Allowance for Uncollectible Accounts*, accounts receivable arising from filing fee transactions were entity funds for periods before FY 2012 and non-entity funds beginning in FY 2012. Effective October 1, 2011 and pursuant to Section 991(e) of the Dodd-Frank Act, filing fee accounts receivable in excess of the amounts deposited into the Reserve Fund are now held on behalf of the U.S. Treasury and are transferred to the U.S. Treasury General Fund upon collection.

NOTE 7. General Property, Plant and Equipment, Net

At September 30, 2012, property and equipment consisted of the following:

Class of Property *(DOLLARS IN THOUSANDS)*	**Depreciation/ Amortization Method**	**Capitalization Threshold for Individual Purchases**	**Capitalization Threshold for Bulk Purchases**	**Service Life (Years)**	**Acquisition Cost**	**Accumulated Depreciation/ Amortization**	**Book Value**
Furniture and Equipment	S/L	$ 15	$ 50	3-5	$ 96,240	$ 56,715	$ 39,525
Software	S/L	300	300	3-5	109,480	87,109	22,371
Leasehold Improvements	S/L	300	N/A	10	92,556	56,882	35,674
Total					$ 298,276	$ 200,706	$ 97,570

At September 30, 2011, property and equipment consisted of the following:

Class of Property *(DOLLARS IN THOUSANDS)*	**Depreciation/ Amortization Method**	**Capitalization Threshold for Individual Purchases**	**Capitalization Threshold for Bulk Purchases**	**Service Life (Years)**	**Acquisition Cost**	**Accumulated Depreciation/ Amortization**	**Book Value**
Furniture and Equipment	S/L	$ 15	$ 50	3-5	$ 81,626	$ 47,455	$ 34,171
Software	S/L	300	300	3-5	97,139	80,392	16,747
Leasehold Improvements	S/L	300	N/A	10	90,993	47,972	43,021
Total					$ 269,758	$ 175,819	$ 93,939

NOTE 8. Liabilities Covered and Not Covered by Budgetary Resources

The SEC's liabilities include amounts that will not require the use of budgetary resources. These liabilities include registrant deposit accounts that have not been returned to registrants and the offsetting liability that corresponds to assets the SEC holds relating to collections from disgorgements and penalties and receivables as discussed in *Note 1.M, Liabilities*.

At September 30, 2012, liabilities consisted of the following:

(DOLLARS IN THOUSANDS)	Liabilities Covered by Budgetary Resources	Liabilities Not Covered by Budgetary Resources	Liabilities Not Requiring Budgetary Resources	Total
Intragovernmental:				
Accounts Payable	$ 8,829	$ —	$ —	$ 8,829
Other Intragovernmental Liabilities				
Accrued Employee Benefits	2,426	2,758	—	5,184
Unfunded FECA and Unemployment Liability	—	1,441	—	1,441
Custodial Liability	—	—	62,497	62,497
Liability for Non-Entity Assets	—	—	2,457	2,457
Subtotal – Other Intragovernmental Liabilities	2,426	4,199	64,954	71,579
Total Intragovernmental	11,255	4,199	64,954	80,408
Accounts Payable	39,474	—	—	39,474
Actuarial FECA Liability	—	8,050	—	8,050
Other Liabilities				
Accrued Payroll and Benefits	13,765	—	—	13,765
Accrued Leave	—	48,531	—	48,531
Registrant Deposits	—	—	33,689	33,689
Liability for Disgorgement and Penalties (Note 16)	—	—	932,763	932,763
Other Accrued Liabilities				
Legal Liability	—	—	—	—
Recognition of Lease Liability (Note 9)	—	5,708	—	5,708
Other	7	—	50	57
Subtotal – Other Liabilities	13,772	54,239	966,502	1,034,513
Total Liabilities	$ 64,501	$ 66,488	$ 1,031,456	$ 1,162,445

Other Liabilities (intragovernmental and governmental) totaled $1,106 million as of September 30, 2012, of which all but $57 million is current. The non-current portion of Other Liabilities includes the appropriate portions of Accrued Employee Benefits, Unfunded FECA and Unemployment Liability, Accrued Leave, Contingent Liabilities, and Lease Liability. Current liabilities not covered by budgetary resources totaled $1.4 million as of September 30, 2012.

At September 30, 2011, liabilities consisted of the following:

(DOLLARS IN THOUSANDS)	Liabilities Covered by Budgetary Resources	Liabilities Not Covered by Budgetary Resources	Liabilities Not Requiring Budgetary Resources	Total
Intragovernmental:				
Accounts Payable	$ 8,049	$ —	$ —	$ 8,049
Other Intragovernmental Liabilities				
Accrued Employee Benefits	2,877	—	—	2,877
Unfunded FECA and Unemployment Liability	—	1,770	—	1,770
Custodial Liability	—	—	51,745	51,745
Liability for Non-Entity Assets	—	—	134	134
Subtotal – Other Intragovernmental Liabilities	2,877	1,770	51,879	56,526
Total Intragovernmental	10,926	1,770	51,879	64,575
Accounts Payable	52,768	—	—	52,768
Actuarial FECA Liability	—	7,805	—	7,805
Other Liabilities				
Accrued Payroll and Benefits	18,395	—	—	18,395
Accrued Leave	—	45,472	—	45,472
Registrant Deposits	—	—	46,622	46,622
Liability for Disgorgement and Penalties (Note 16)	—	—	862,976	862,976
Other Accrued Liabilities				
Legal Liability	—	956	—	956
Recognition of Lease Liability (Note 9)	—	6,256	—	6,256
Other	—	—	—	—
Subtotal – Other Liabilities	18,395	52,684	909,598	980,677
Total Liabilities	$ 82,089	$ 62,259	$ 961,477	$ 1,105,825

Other Liabilities (intragovernmental and governmental) totaled $1,037 million as of September 30, 2011, of which all but $51 million is current. The non-current portion of Other Liabilities includes the appropriate portions of the Unfunded FECA and Unemployment Liability, Accrued Leave, and Lease Liability. Current liabilities not covered by budgetary resources totaled $3.6 million as of September 30, 2011.

The legal liability arose from an award ordered pursuant to case *SEC v. FLRA*, No. 08-1256, 08-1294 (D.C.Cir.). This matter involved a complaint filed by the National Treasury Employees Union (NTEU) before Federal Labor Relations Authority (FLRA). In FY 2010, the SEC developed a methodology for processing the ordered retroactive wage adjustments and began making payments in the fourth quarter of FY 2010. The legal liability was fully resolved during FY 2012.

NOTE 9. Leases

Operating Leases

At September 30, 2012, the SEC leased office space at 16 locations under operating lease agreements that expire between FY 2013 and FY 2027. The SEC paid $103 million and $99.6 million for rent for the years ended September 30, 2012 and 2011, respectively.

Under existing commitments, expected future lease payments through FY 2018 and thereafter are as follows:

Fiscal Year *(DOLLARS IN THOUSANDS)*	Expected Future Lease Payments
2013	$ 93,363
2014	90,688
2015	84,551
2016	81,301
2017	79,914
2018 and thereafter	202,896
Total Expected Future Lease Payments	$ 632,713

The total expected future lease payments presented above reflects an estimate of base rent, option years, and contractually required costs.

Constitution Center Property

The SEC leased approximately 900,000 square feet of office space at Constitution Center in July 2010. In the first quarter of FY 2011, the SEC determined that it would not have a need for the space and reached an agreement to transfer 600,000 square feet back to the lessor. In June 2012, the SEC and U.S. General Services Administration (GSA) signed a memorandum of agreement transferring a leasehold interest in the remaining space of approximately 300,000 square feet to GSA as excess property. GSA assumes responsibility for the payment of rent to the lessor upon the earlier of December 1, 2013 or the date that it is rented by GSA to a client agency. Total future expected lease payments summarized above reflect the elimination of $137.7 million attributable to the Constitution Center property as compared to the September 2011 disclosure. See additional information at *Note 14.C, Other Budgetary Disclosures*.

Expense Recognition of "Rent Holiday"

In FY 2005, the SEC moved into temporary office space in New York due to renovations in the new leased office space. This temporary space was provided to the SEC for only the lessor's operating costs. As a result, the SEC recognized $8 million of rent expense discount, which is being amortized on a straight-line basis over the 15 year life of the new lease. Amortization of the discount recognized in FY 2012 and FY 2011 totaled $533 thousand in each year, respectively. The unamortized balance at September 30, 2012 and 2011 totaled $4.5 million and $5.1 million, respectively.

In November 2011, the SEC occupied leased office space in Atlanta, Georgia. The lease term is 15 years and includes a one year rent payment holiday. The SEC expects to amortize $1.4 million of rent expense discount over the non-cancellable term of the lease which is 10 years. The SEC has recognized an annual rent expense of $1.2 million for FY 2012.

NOTE 10. Commitments and Contingencies

A. Commitments: Securities Investor Protection Act

The Securities Investor Protection Act of 1970 (SIPA), as amended, created the Securities Investor Protection Corporation (SIPC) to restore funds and securities to investors and to protect the securities markets from disruption following the failure of broker-dealers. Generally, if a brokerage firm is not able to meet its obligations to customers, then customers' cash and securities held by the brokerage firm are returned to customers on a pro rata basis. If sufficient funds are not available at the firm to satisfy customer claims, the reserve funds of SIPC are used to supplement the distribution, up to a ceiling of $500,000 per customer, including a maximum of $250,000 for cash claims.

SIPA authorizes SIPC to create a fund to maintain all monies received and disbursed by SIPC. SIPA gives SIPC the authority to borrow up to $2.5 billion from the SEC in the event that the SIPC Fund is or may appear insufficient for purposes of SIPA. To borrow the funds, SIPC must file with the SEC a statement of the uses of such a loan and a repayment plan, and then the SEC must certify to the Secretary of the Treasury that the loan is necessary to protect broker-dealer customers and maintain confidence in the securities markets and that the repayment plan provides a reasonable assurance of prompt repayment as may be feasible under the circumstances. The Treasury would make these funds available to the SEC through the purchase of notes or other obligating instruments issued by the SEC. Such notes or other obligating instruments would bear interest at a rate determined by the Secretary of the Treasury. As of September 30, 2012, the SEC had not loaned any funds to the SIPC, and there are no outstanding notes or other obligating instruments issued by the SEC.

Based on the estimated costs to complete ongoing customer protection proceedings, the current size of the SIPC Fund supplemented by SIPC's ongoing assessments on brokers is expected to provide sufficient funds to cover acknowledged customer claims. There are several broker-dealers that are being liquidated under SIPA or that have been referred to SIPC for liquidation that may result in additional customer claims. In the event that the SIPC Fund is or may reasonably appear to be insufficient for the purposes of SIPA, SIPC may seek a loan from the SEC.

B. Commitments and Contingencies: Investor Protection Fund

As mentioned in *Note 1.E, Fund Accounting Structure*, the Investor Protection Fund is used to pay awards to whistleblowers if they voluntarily provide original information to the SEC and meet other conditions. The legislation allows whistleblowers to receive between 10 and 30 percent of the monetary sanctions collected in the covered action or in a related action, with the actual percentage being determined at the discretion of the SEC using criteria provided in the legislation and the related rules to implement the legislation adopted by the SEC.

A Preliminary Determination is a first assessment, made by the Claims Review Staff, as to whether the claim should be allowed or denied and, if allowed, what the proposed award percentage amount should be. A contingent liability is recognized in instances where a positive Preliminary Determination (payment of award is probable) has been made by the Claims Review Staff in the Office of the Whistleblower and the amount can be reasonably estimated. Liabilities are recognized in instances where a collection has been received and a positive Proposed Final Determination has been reached by the Claims Review Staff. However, the actual payment of the whistleblower award would not occur until after the final order was issued by the Commission.

The SEC did not recognize a contingent liability (not covered by budgetary resources) for potential whistleblower awards as of September 30, 2012. During FY 2012, the SEC made its first whistleblower award, paying the claimant $46 thousand. The payment amount was determined by applying the award percentage to the monetary sanctions actually collected in the covered action. If and when additional amounts are collected on the monetary sanction, additional amounts will be paid out to the claimant. The total potential whistleblower payments payable under this covered action is approximately $2.3 million dollars. A contingent liability is not recorded for this action because future whistleblower payments are dependent on actual future cash collections which have yet to be determined.

C. Other Commitments

In addition to future lease commitments discussed in *Note 9, Leases*, the SEC is obligated for the purchase of goods and services that have been ordered, but not received. As of September 30, 2012, net obligations for all of the SEC's activities were $954.4 million, of which $64.5 million was delivered and unpaid. As of September 30, 2011, net obligations for all of SEC's activities were $1,110.6 million, of which $82.1 million was delivered and unpaid.

D. Other Contingencies

The SEC recognizes contingent liabilities when a past event or exchange transaction has occurred, a future outflow or other sacrifice of resources is probable, and the future outflow or sacrifice of resources is estimable. The SEC is party to various routine administrative proceedings, legal actions, and claims brought against it, including threatened or pending litigation involving labor relations claims, some of which may ultimately result in settlements or decisions against the Federal Government. No amounts have been accrued in the financial statements for claims where the amount is uncertain or where the probability of judgment against the SEC is remote.

NOTE 11. Earmarked Funds

The SEC's Earmarked funds consist of transactions and balances recorded in its Salaries and Expenses Fund, Investor Protection Fund, and Reserve Fund. See *Note 1.F, Earmarked Funds*. Also see *Note 5, Investments*, for additional information about intragovernmental investments in Treasury securities.

For FY 2012, the assets, liabilities, net position, and net income from operations relating to earmarked funds consisted of the following:

(DOLLARS IN THOUSANDS)	Salaries & Expenses	Investor Protection Fund	Reserve Fund	Eliminations	Total Earmarked Funds
Balance Sheet as of September 30, 2012					
ASSETS					
Fund Balance with Treasury	$7,016,133	$ 957	$ 50,000	$ —	$ 7,067,090
Cash and Other Monetary Assets	8	—	—	—	8
Investments, Net	—	452,472	—	—	452,472
Accounts Receivable, Net	103,312	—	—	—	103,312
Advances and Prepayments	8,059	—	—	—	8,059
Property and Equipment, Net	96,374	—	—	—	96,374
Total Assets	$7,223,886	$ 453,429	$ 50,000	$ —	$ 7,727,315
LIABILITIES					
Accounts Payable	$ 48,289	$ —	$ 10	$ —	$ 48,299
FECA and Unemployment Liability	9,491	—	—	—	9,491
Accrued Payroll and Benefits	18,949	—	—	—	18,949
Accrued Leave	48,531	—	—	—	48,531
Other Accrued Liabilities	5,715	—	—	—	5,715
Total Liabilities	130,975	—	10	—	130,985
NET POSITION					
Cumulative Results of Operations	7,092,911	453,429	49,990	—	7,596,330
Total Net Position	7,092,911	453,429	49,990	—	7,596,330
Total Liabilities and Net Position	$7,223,886	$ 453,429	$ 50,000	$ —	$ 7,727,315
Statement of Net Cost for the year ended September 30, 2012					
Gross Program Costs	$1,195,721	$ 116	$ 10	$ (70)	$ 1,195,777
Less Earned Revenues Not Attributable to Program Costs	1,269,829	—	50,000	(70)	1,319,759
Net (Income) Cost from Operations	$ (74,108)	$ 116	$ (49,990)	$ —	$ (123,982)
Statement of Changes in Net Position for the year ended September 30, 2012					
Cumulative Results of Operations					
Beginning Balances	$6,956,398	$ 452,788	$ —	$ —	$ 7,409,186
Appropriations Used	32,601	—	—	—	32,601
Non-Exchange Revenue	—	757	—	—	757
Transfers In/Out Without Reimbursement	(784)	—	—	—	(784)
Imputed Financing	30,588	—	—	—	30,588
Net Income (Cost) from Operations	74,108	(116)	49,990	—	123,982
Net Change	136,513	641	49,990	—	187,144
Cumulative Results of Operations	7,092,911	453,429	49,990	—	7,596,330
Unexpended Appropriations					
Appropriations Received	32,601	—	—	—	32,601
Appropriations Used	(32,601)	—	—	—	(32,601)
Net Position, End of Period	$7,092,911	$ 453,429	$ 49,990	$ —	$ 7,596,330

For FY 2011, the assets, liabilities, net position, and net income from operations relating to earmarked funds consisted of the following:

(DOLLARS IN THOUSANDS)	Salaries & Expenses	Investor Protection Fund	Reserve Fund	Eliminations	Total Earmarked Funds
Balance Sheet as of September 30, 2011					
ASSETS					
Fund Balance with Treasury	$6,874,218	$ 73	$ —	$ —	$ 6,874,291
Cash and Other Monetary Assets	—	—	—	—	—
Investments, Net	—	452,715	—	—	452,715
Accounts Receivable, Net	122,930	—	—	—	122,930
Advances and Prepayments	10,828	—	—	—	10,828
Property and Equipment, Net	92,736	—	—	—	92,736
Total Assets	$7,100,712	$452,788	$ —	$ —	$ 7,553,500
LIABILITIES					
Accounts Payable	$ 60,783	$ —	$ —	$ —	$ 60,783
FECA and Unemployment Liability	9,575	—	—	—	9,575
Accrued Payroll and Benefits	21,272	—	—	—	21,272
Accrued Leave	45,472	—	—	—	45,472
Other Accrued Liabilities	7,212	—	—	—	7,212
Total Liabilities	144,314	—	—	—	144,314
NET POSITION					
Cumulative Results of Operations	6,956,398	452,788	—	—	7,409,186
Total Net Position	6,956,398	452,788	—	—	7,409,186
Total Liabilities and Net Position	$7,100,712	$ 452,788	$ —	$ —	$ 7,553,500
Statement of Net Cost for the year ended September 30, 2011					
Gross Program Costs	$1,145,097	$ 112	$ —	$ (112)	$ 1,145,097
Less Earned Revenues Not Attributable to Program Costs	1,640,893	—	—	(112)	1,640,781
Net (Income) Cost from Operations	$ (495,796)	$ 112	$ —	$ —	$ (495,684)
Statement of Changes in Net Position for the year ended September 30, 2011					
Cumulative Results of Operations					
Beginning Balances	$6,426,222	$ 451,910	$ —	$ —	$ 6,878,132
Appropriations Used	—	—	—	—	—
Non-Exchange Revenue	—	990	—	—	990
Transfers In/Out Without Reimbursement	—	—	—	—	—
Imputed Financing	34,380	—	—	—	34,380
Net Income (Cost) from Operations	495,796	(112)	—	—	495,684
Net Change	530,176	878	—	—	531,054
Cumulative Results of Operations	6,956,398	452,788	—	—	7,409,186
Unexpended Appropriations					
Appropriations Received	—	—	—	—	—
Appropriations Used	—	—	—	—	—
Net Position, End of Period	$6,956,398	$ 452,788	$ —	$ —	$ 7,409,186

NOTE 12. Intragovernmental Costs and Exchange Revenue

The Statement of Net Cost presents the SEC's results of operations for its major programs. The SEC assigns all costs incurred to ten programs, consistent with its budget submissions. The full cost of SEC programs is the sum of (1) the costs of resources directly or indirectly consumed by those programs, and (2) the costs of identifiable supporting services provided by other responsibility segments within the agency. Typical examples of indirect costs include costs of general administrative services, technical support, security, rent, and operating and maintenance costs for buildings, equipment, and utilities. The SEC allocates support costs to its programs using activity-based cost accounting.

Intragovernmental costs arise from purchases of goods and services from other components of the Federal Government. In contrast, public costs are those which arise from the purchase of goods and services from non-Federal entities.

Exchange revenue is not directly assignable to a specific program and is presented in total. The Statements of Net Cost, for the years ended September 30, 2012 and 2011, with a breakout of intragovernmental and public costs is presented below.

	FY 2012		
(DOLLARS IN THOUSANDS)	**Intragovernmental Gross Cost**	**Gross Cost with the Public**	**Total**
SEC Programs:			
Enforcement	$ 73,629	$ 326,945	$ 400,574
Compliance Inspections and Examinations	43,331	192,406	235,737
Corporation Finance	25,263	112,178	137,441
Trading and Markets	12,487	55,449	67,936
Investment Management	8,866	39,372	48,238
Risk, Strategy, and Financial Innovation	3,730	16,566	20,296
General Counsel	7,528	33,423	40,951
Other Program Offices	8,968	39,823	48,791
Agency Direction and Administrative Support	34,982	155,332	190,314
Inspector General	1,330	5,908	7,238
Total Program Costs	$ 220,114	$ 977,402	1,197,516
Less: Exchange Revenues			
Securities Transaction Fees			1,269,612
Securities Registration, Tender Offer, and Merger Fees			378,028
Other			219
Total Exchange Revenues			1,647,859
Net (Income) Cost from Operations			$ (450,343)

(DOLLARS IN THOUSANDS)	FY 2011 Intragovernmental Gross Cost	Gross Cost with the Public	Total
SEC Programs:			
Enforcement	$ 72,533	$ 318,650	$ 391,183
Compliance Inspections and Examinations	44,396	195,039	239,435
Corporation Finance	24,412	107,248	131,660
Trading and Markets	11,528	50,648	62,176
Investment Management	8,759	38,481	47,240
Risk, Strategy, and Financial Innovation	3,723	16,357	20,080
General Counsel	7,668	33,689	41,357
Other Program Offices	8,367	36,755	45,122
Agency Direction and Administrative Support	30,290	133,067	163,357
Inspector General	1,210	5,318	6,528
Total Program Costs	$ 212,886	$ 935,252	1,148,138
Less: Exchange Revenues			
Securities Transaction Fees			1,279,260
Securities Registration, Tender Offer, and Merger Fees			361,284
Other			3,186
Total Exchange Revenues			1,643,730
Net (Income) Cost from Operations			$ (495,592)

Intragovernmental exchange revenue was $147 thousand and $236 thousand for the years ended September 30, 2012 and 2011, respectively.

NOTE 13. Imputed Financing

A portion of the retirement, health, and life insurance benefits provided to SEC employees is funded by OPM. In accordance with Federal accounting standards, the SEC recognizes identified costs paid by OPM on behalf of the SEC as an expense. The funding for this expense is reflected as imputed financing on the Statement of Changes in Net Position. Costs paid by OPM on behalf of the SEC were $30.5 million and $34.4 million in FY 2012 and FY 2011, respectively. In addition, imputed financing includes $0.1 million for claims paid by the U.S. Treasury's Judgment fund on behalf of the SEC.

NOTE 14. Status of Budgetary Resources

A. Apportionment Categories of Obligations Incurred

Category A funds are those amounts that are subject to quarterly apportionment by OMB, meaning that a portion of the annual appropriation is not available to the agency until apportioned each quarter. Category B funds represent budgetary resources distributed by a specified time period, activity, project, object, or a combination of these categories. The SEC's Category B funds represent amounts apportioned at the beginning of the fiscal year for the SEC's reimbursable and Investor Protection Fund activities. The SEC's Reserve Fund is exempt from apportionment. For additional information, see *Note 1.E, Fund Accounting Structure,* and *Note 1.R, Budgets and Budgetary Accounting*. For the years ended September 30, 2012 and 2011, the SEC incurred obligations against Category A, Category B, and Exempt funds as follows:

Obligations Incurred *(DOLLARS IN THOUSANDS)*	**FY 2012**	**FY 2011**
Direct Obligations		
Category A	$ 1,179,640	$ 1,215,032
Category A — Change in Legal Interpretation for Lease Obligations	—	777,928
Category B — Investor Protection Fund	116	112
Exempt From Apportionment — Reserve Fund	12,358	—
Total Direct Obligations	1,192,114	1,993,072
Reimbursable Obligations		
Category B	271	388
Total Obligations Incurred	$ 1,192,385	$ 1,993,460

In addition, the amounts of budgetary resources obligated for undelivered orders include $890.1 million and $1,028.5 million at September 30, 2012 and 2011, respectively.

B. Explanation of Differences between the Statement of Budgetary Resources and the Budget of the U.S. Government

A comparison between the FY 2012 SBR and the actual FY 2012 data in the President's budget cannot be presented, as the FY 2014 President's budget which will contain FY 2012 actual data is not yet available. The comparison will be presented in next year's financial statements. The comparison as of September 30, 2011 is presented below:

(DOLLARS IN MILLIONS)	**Budgetary Resources**	**Obligations Incurred**	**Distributed Offsetting Receipts**	**Net Outlays**
Combined Statement of Budgetary Resources	$ 1,713	$ 1,993	$ 1	$ 436
Comptroller General Decision B 322160, *Recording of Obligation for Multiple Year Contract*	(47)	(778)	—	—
Rounding	—	—	—	1
Budget of the U.S. Government	$ 1,666	$ 1,215	$ 1	$ 437

The differences in Budgetary Resources and Obligations Incurred stem from the SEC's recording of obligations in FY 2011 to reflect the impact of Comptroller General Decision B 322160, Securities and Exchange Commission - Recording of Obligation for Multiple-Year Contract.

In consultation with OMB, the SEC recognized on the FY 2011 SBR new obligations of $778 million related to leases entered into in FY 2010 and prior. These obligations were reported as an adjustment to prior year activity (FY 2010 and prior) in the FY 2011 Budget of the U.S. Government. Although the line items used to report these obligations were different, there was no difference between the SEC's FY 2011 SBR and the FY 2011 Budget of the U.S. Government in the impact of the $778 million adjustment on the FY 2011 year-end totals.

In addition, the recognition of these lease obligations resulted in an unfunded deficiency. OMB procedures for preparation of the Budget automatically applied the full amount of unobligated balances in SEC's Salaries and Expense Account of $47 million against this unfunded deficiency at the end of FY 2011 in the Budget of the U.S. Government. There is no corresponding line in the SBR for this disaggregation of the net unfunded deficiency.

The difference of $1 million in Net Outlays was due to differences in rounding.

C. Other Budgetary Disclosures

General Provisions of Appropriation

The SEC's annual Appropriations Act contains general provisions which limit the amount that can be obligated for international conferences, International Organization of Securities Commission (IOSCO) dues, and representation expenses. The act also requires the SEC to fund its Office of Inspector General with a minimum of $6,795,000.

The SEC's FY 2012 appropriation bill included a provision which temporarily rescinded $25 million in appropriations recognized in SEC's Reserve Fund until FY 2013. As a result, the SEC may only obligate $25 million from the Reserve Fund in FY 2012.

Change in Legal Interpretation for Lease Obligations

The SEC was granted independent leasing authority in 1990. Based on a legal review of its statutory authority at the time, the SEC adopted a policy of obligating only the annual portion of lease payments due each year. On October 3, 2011, the Government Accountability Office (GAO) issued a decision that this longstanding practice of recording lease obligations only on an annual basis violated the recording statute, 31 U.S.C. sect. 1501(a)(1). Specifically, the GAO's decision was that the SEC lacks statutory authority to obligate an amount less than the Government's total obligation. If the SEC lacks sufficient budget authority to cover this obligation, the SEC should report a violation of the Antideficiency Act (ADA).

The SEC recorded obligations in the same manner for all its leasing actions between the time the agency was granted independent leasing authority in 1990 and 2010. Further, the agency did not have sufficient remaining unobligated funds in the years in which the various leases were entered to cover the full obligations associated with those leases. As a result, the agency recorded unfunded obligations totaling $778 million for leases executed between 1990 and 2010 in FY 2011. The SEC appropriately obligated the Government's total financial responsibility for lease actions that were executed in FY 2011 and FY 2012.

Unfunded lease obligations totaled $523 million as of September 30, 2012. The change in unfunded obligations is due to the SEC funding previously unfunded obligations totaling $113 million and also recording downward adjustments to previous year unfunded lease obligations totaling $142 million. The downward adjustment includes $137.7 million resulting from an agreement signed in June 2012 transferring responsibility for the Constitution Center from the SEC to GSA. See *Note 9, Leases*, for additional information.

See *Note 10.A, Commitments: Securities Investor Protection Act*, for information on the SEC's borrowing authority.

NOTE 15. Reconciliation of Net Cost of Operations to Budget

For the years ended September 30, 2012 and 2011:

(DOLLARS IN THOUSANDS)	**FY 2012**	**FY 2011**
RESOURCES USED TO FINANCE ACTIVITIES:		
Budgetary Resources Obligated:		
Obligations Incurred (Note 14)	$ 1,192,385	$ 1,993,460
Less: Spending Authority from Offsetting Collections, Recoveries, and Downward Adjustments to Prior Year Unfunded Lease Obligations	(1,457,761)	(1,637,034)
Less: Reserve Fund Appropriations	(50,000)	—
Net Obligations	(315,376)	356,426
Other Resources:		
Imputed Financing from Cost Absorbed by Others (Note 13)	30,588	34,380
Total Resources Used to Finance Activities	(284,788)	390,806
RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST OF OPERATIONS:		
Change in Budgetary Resources Obligated for Goods, Services, and Benefits Ordered But Not Yet Provided	141,372	(815,449)
Resources that Finance the Acquisition of Assets Capitalized on the Balance Sheet	(40,684)	(43,809)
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	100,688	(859,258)
Total Resources Used to Finance the Net Cost of Operations	(184,100)	(468,452)
COMPONENTS OF NET COST OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD:		
Components Requiring or Generating Resources in Future Periods:		
Change in Accrued Leave Liability	3,059	(157)
Change in Revenue Receivables Not Generating Resources Until Collected	18,814	(43,710)
Change in Lease Liability	(548)	(2,946)
Change in Legal Liability	(956)	(9,867)
Change in Unfunded Liability	2,674	280
Total Components of Net Cost of Operations that will Require or Generate Resources in Future Periods	23,043	(56,400)
Components not Requiring or Generating Resources:		
Depreciation and Amortization	36,607	27,951
Revaluation of Assets or Liabilities	446	1,631
Non-Entity Filing Fee Revenue, Net	(326,284)	—
Other Costs that will not Require or Generate Resources	(55)	(322)
Total Components of Net Cost of Operations that will not Require or Generate Resources in Future Periods	(289,286)	29,260
Total Components of Net Cost of Operations that will not Require or Generate Resources in the Current Period	(266,243)	(27,140)
Net (Income) Cost from Operations	$ (450,343)	$ (495,592)

NOTE 16. Disgorgement and Penalties

The SEC's non-entity assets include disgorgement, penalties, and interest assessed against securities law violators by the Commission, administrative law judge, or in some cases, a court. The SEC also recognizes an equal and offsetting liability for these non-entity assets, as discussed in *Note 1.M, Liabilities*.

When the Commission or court issues an order for the SEC to collect disgorgement, penalties, and interest from securities law violators, the SEC establishes an account receivable due to the SEC. Upon collection, the SEC may (a) hold receipts in the Disgorgement and Penalty Deposit Fund as FBWT or Treasury investments pending distribution to harmed investors, (b) deposit receipts in the U.S. Treasury General Fund or, (c) transfer amounts to the Investor Protection Fund. The situations where funds would not be held for distribution to harmed investors arise when the SEC either determines it is not practical to return funds to investors or when court orders expressly state that funds are to be remitted to the U.S. Treasury. The determination as to whether funds not held for distribution to harmed investors will be deposited in the U.S. Treasury or transferred to the Investor Protection Fund is made in accordance with the provisions of the Dodd-Frank Act, and is dependent on the balance in the Investor Protection Fund on the day the amounts are collected. (See *Note 1.T, Investor Protection Fund*).

Disbursements related to disgorgements and penalties include distributions to harmed investors, payments to tax authorities, and fees paid to plan administrators and the Bureau of Public Debt. The SEC does not record accounts receivable on its financial statements for any amounts ordered to another Government entity such as a court, or a non-governmental entity such as a receiver. Additional details regarding disgorgement and penalties are presented in *Note 1.S, Disgorgement and Penalties*, and *Note 2, Entity and Non-Entity Assets*.

At September 30, the net inflows and outflows for FBWT, Investments, and Accounts Receivable related to disgorgement and penalties consisted of the following:

(DOLLARS IN THOUSANDS)	**FY 2012**	**FY 2011**
Fund Balance with Treasury:		
Beginning Balance	$ 73,929	$ 54,269
Collections	622,529	544,200
Purchases and Redemptions of Treasury Securities	228,513	175,520
Disbursements	(205,440)	(286,647)
Transfers and Deposits to the U.S. Treasury General Fund	(377,645)	(413,413)
Total Fund Balance with Treasury (Note 2)	341,886	73,929
Cash and Other Monetary Assets:		
Beginning Balance	—	2,815
Net Activity	1,058	(2,815)
Total Cash and Other Monetary Assets (Notes 2 and 4)	1,058	—
Investments, Net:		
Beginning Balance	749,810	924,823
Net Activity	(228,366)	(175,013)
Total Investments, Net (Notes 2 and 5)	521,444	749,810
Accounts Receivable, Net:		
Beginning Balance	90,982	81,939
Net Activity	39,634	9,043
Total Accounts Receivable, Net (Notes 2 and 6)	130,616	90,982
Total Disgorgement and Penalties	$ 995,004	$ 914,721

Required Supplementary Information (Unaudited)

This section provides the Required Supplementary Information as prescribed by OMB Circular A-136, *Financial Reporting Requirements*.

Statements of Budgetary Resources by Fund

For the year ended September 30, 2012:

(DOLLARS IN THOUSANDS)	**Salaries and Expenses and Other Funds**	**Investor Protection Fund**	**Reserve Fund**	**Total**
	X0100, 09/10 0100, 1435, 3220	**5567**	**5566**	
BUDGETARY RESOURCES:				
Unobligated Balance, Brought Forward, October 1	$ (730,880)	$ 450,951	$ —	$ (279,929)
Recoveries of Prior Year Unpaid Obligations	26,688	—	—	26,688
Downward Adjustments of Prior Year Unfunded Lease Obligations (Note 14.C)	141,933	—	—	141,933
Unobligated Balance from Prior Year Budget Authority, Net	(562,259)	450,951	—	(111,308)
Appropriations (Discretionary and Mandatory)	32,601	625	25,000	58,226
Spending Authority from Offsetting Collections (Discretionary and Mandatory)	1,289,139	—	—	1,289,139
Total Budgetary Resources	$ 759,481	$ 451,576	$ 25,000	$ 1,236,057
STATUS OF BUDGETARY RESOURCES:				
Obligations Incurred (Note 14):				
Direct and Reimbursable	$ 1,179,911	$ 116	$ 12,358	$ 1,192,385
Change in Legal Interpretation for Lease Obligations	—	—	—	—
Subtotal	1,179,911	116	12,358	1,192,385
Unobligated Balance, End of Year:				
Apportioned	71,533	451,460	—	522,993
Exempt from Apportionment	—	—	12,642	12,642
Unapportioned	(491,963)	—	—	(491,963)
Total Unobligated Balance, End of Year	(420,430)	451,460	12,642	43,672
Total Budgetary Resources	$ 759,481	$ 451,576	$ 25,000	$ 1,236,057
CHANGE IN OBLIGATED BALANCE:				
Unpaid Obligations, Brought Forward, October 1 (Gross)	$ 1,110,634	$ —	$ —	$ 1,110,634
Uncollected Customer Payments from Federal Sources, Brought Forward, October 1	(47)	—	—	(47)
Obligated Balance, Start of Year (Net)	1,110,587	—	—	1,110,587
Obligations Incurred	1,179,911	116	12,358	1,192,385
Outlays (Gross)	(1,179,684)	(116)	—	(1,179,800)
Change in Uncollected Customer Payments from Federal Sources	(142)	—	—	(142)
Recoveries of Prior Year Unpaid Obligations	(26,688)	—	—	(26,688)
Downward Adjustments of Prior Year Unfunded Lease Obligations (Note 14.C)	(141,933)	—	—	(141,933)
Total Obligated Balance, End of Year	$ 942,051	$ —	$ 12,358	$ 954,409
Obligated Balance, End of Year				
Unpaid Obligations, End of Year (Gross)	$ 942,240	$ —	$ 12,358	$ 954,598
Uncollected Customer Payments from Federal Sources, End of Year	(189)	—	—	(189)
Obligated Balance, End of Year (Net)	$ 942,051	$ —	$ 12,358	$ 954,409
BUDGET AUTHORITY AND OUTLAYS, NET:				
Budget Authority, Gross (Discretionary and Mandatory)	$ 1,321,740	$ 625	$ 25,000	$ 1,347,365
Actual Offsetting Collections (Discretionary and Mandatory)	(1,288,998)	—	—	(1,288,998)
Change in Uncollected Customer Payments from Federal Sources (Discretionary and Mandatory)	(142)	—	—	(142)
Budget Authority, Net (Discretionary and Mandatory)	$ 32,600	$ 625	$ 25,000	$ 58,225
Outlays, Gross (Discretionary and Mandatory)	$ 1,179,684	$ 116	$ —	$ 1,179,800
Actual Offsetting Collections (Discretionary and Mandatory)	(1,288,998)	—	—	(1,288,998)
Outlays, Net (Discretionary and Mandatory)	(109,314)	116	—	(109,198)
Distributed Offsetting Receipts	(498)	(625)	—	(1,123)
Agency Outlays, Net (Discretionary and Mandatory)	$ (109,812)	$ (509)	$ —	$ (110,321)

For the year ended September 30, 2011:

(DOLLARS IN THOUSANDS)	Salaries and Expenses and Other Funds	Investor Protection Fund	Reserve Fund	Total
	X0100, 09/10 0100, 1435, 3220	5567	5566	
BUDGETARY RESOURCES:				
Unobligated Balance, Brought Forward, October 1	$ 37,439	$ 451,910	$ —	$ 489,349
Recoveries of Prior Year Unpaid Obligations	38,945	—	—	38,945
Downward Adjustments of Prior Year Unfunded Lease Obligations (Note 14.C)	—	—	—	—
Unobligated Balance from Prior Year Budget Authority, Net	76,384	451,910		528,294
Appropriations (Discretionary and Mandatory)	—	(847)	—	(847)
Spending Authority from Offsetting Collections (Discretionary and Mandatory)	1,186,084	—	—	1,186,084
Total Budgetary Resources	$ 1,262,468	$ 451,063	$ —	$ 1,713,531
STATUS OF BUDGETARY RESOURCES:				
Obligations Incurred (Note 14):				
Direct and Reimbursable	$ 1,215,420	$ 112	$ —	$ 1,215,532
Change in Legal Interpretation for Lease Obligations	777,928	—	—	777,928
Subtotal	1,993,348	112	—	1,993,460
Unobligated Balance, End of Year:				
Apportioned	8,297	450,951	—	459,248
Exempt from Apportionment	—	—	—	—
Unapportioned	(739,177)	—	—	(739,177)
Total Unobligated Balance, End of Year	(730,880)	450,951	—	(279,929)
Total Budgetary Resources	$ 1,262,468	$ 451,063	$ —	$ 1,713,531
CHANGE IN OBLIGATED BALANCE:				
Unpaid Obligations, Brought Forward, October 1 (Gross)	$ 317,772	$ —	$ —	$ 317,772
Uncollected Customer Payments from Federal Sources, Brought Forward, October 1	(25)	—	—	(25)
Obligated Balance, Start of Year (Net)	317,747	—	—	317,747
Obligations Incurred	1,993,348	112	—	1,993,460
Outlays (Gross)	(1,161,541)	(112)	—	(1,161,653)
Change in Uncollected Customer Payments from Federal Sources	(22)	—	—	(22)
Recoveries of Prior Year Unpaid Obligations	(38,945)	—	—	(38,945)
Downward Adjustments of Prior Year Unfunded Lease Obligations (Note 14.C)	—	—	—	—
Total Obligated Balance, End of Year	$ 1,110,587	$ —	$ —	$ 1,110,587
Obligated Balance, End of Year				
Unpaid Obligations, End of Year (Gross)	$ 1,110,634	$ —	$ —	$ 1,110,634
Uncollected Customer Payments from Federal Sources, End of Year	(47)	—	—	(47)
Obligated Balance, End of Year (Net)	$ 1,110,587	$ —	$ —	$ 1,110,587
BUDGET AUTHORITY AND OUTLAYS, NET:				
Budget Authority, Gross (Discretionary and Mandatory)	$ 1,186,084	$ (847)	$ —	$ 1,185,237
Actual Offsetting Collections (Discretionary and Mandatory)	(1,598,067)	—	—	(1,598,067)
Change in Uncollected Customer Payments from Federal Sources (Discretionary and Mandatory)	(22)	—	—	(22)
Budget Authority, Net (Discretionary and Mandatory)	$ (412,005)	$ (847)	$ —	$ (412,852)
Outlays, Gross (Discretionary and Mandatory)	$ 1,161,541	$ 112	$ —	$ (1,161,653)
Actual Offsetting Collections (Discretionary and Mandatory)	(1,598,067)	—	—	(1,598,067)
Outlays, Net (Discretionary and Mandatory)	(436,526)	112	—	(436,414)
Distributed Offsetting Receipts	(187)	847	—	660
Agency Outlays, Net (Discretionary and Mandatory)	$ (436,713)	$ 959	$ —	$ (435,754)

Investor Protection Fund Financial Statements

Investor Protection Fund Financial Statements

U.S. SECURITIES AND EXCHANGE COMMISSION
INVESTOR PROTECTION FUND

Balance Sheets

As of September 30, 2012 and 2011

(DOLLARS IN THOUSANDS)	FY 2012	FY 2011
ASSETS:		
Intragovernmental:		
Fund Balance with Treasury (Note 2)	$ 957	$ 73
Investments, Net (Note 3)	452,472	452,715
Total Assets	$ 453,429	$ 452,788
LIABILITIES:		
Commitments and Contingencies (Note 4)		
NET POSITION:		
Cumulative Results of Operations – Earmarked Funds	$ 453,429	$ 452,788
Total Liabilities and Net Position	$ 453,429	$ 452,788

The accompanying notes are an integral part of these financial statements.

U.S. SECURITIES AND EXCHANGE COMMISSION
INVESTOR PROTECTION FUND

Statements of Net Cost

For the years ended September 30, 2012 and 2011

(DOLLARS IN THOUSANDS)	FY 2012	FY 2011
PROGRAM COSTS (Note 5):		
Payments to Whistleblowers	$ 46	$ —
Employee Suggestion Program	70	112
Total Program Costs	116	112
Net (Income) Cost from Operations	$ 116	$ 112

The accompanying notes are an integral part of these financial statements.

U.S. SECURITIES AND EXCHANGE COMMISSION
INVESTOR PROTECTION FUND

Statements of Changes in Net Position

For the years ended September 30, 2012 and 2011

(DOLLARS IN THOUSANDS)	FY 2012	FY 2011
CUMULATIVE RESULTS OF OPERATIONS – EARMARKED FUNDS:		
Beginning Balances	$ 452,788	$ 451,910
Budgetary Financing Sources:		
Non-Exchange Revenue	757	990
Net Income (Cost) from Operations	(116)	(112)
Net Change	641	878
Cumulative Results of Operations	453,429	452,788
Net Position, End of Period	$ 453,429	$ 452,788

The accompanying notes are an integral part of these financial statements.

U.S. SECURITIES AND EXCHANGE COMMISSION
INVESTOR PROTECTION FUND

Statements of Budgetary Resources

For the years ended September 30, 2012 and 2011

(DOLLARS IN THOUSANDS)	FY 2012	FY 2011
BUDGETARY RESOURCES:		
Unobligated Balance, Brought Forward, October 1	$ 450,951	$ 451,910
Appropriations (Discretionary and Mandatory)	625	(847)
Total Budgetary Resources	$ 451,576	$ 451,063
STATUS OF BUDGETARY RESOURCES:		
Obligations Incurred - Category B (Note 6)	$ 116	$ 112
Unobligated Balance, End of Year:		
Apportioned	451,460	450,951
Total Budgetary Resources	$ 451,576	$ 451,063
CHANGE IN OBLIGATED BALANCE:		
Obligations Incurred	$ 116	$ 112
Outlays (Gross)	(116)	(112)
Total Obligated Balance, End of Year (Note 6)	$ —	$ —
BUDGET AUTHORITY AND OUTLAYS, NET:		
Budget Authority, Gross (Discretionary and Mandatory)	$ 625	$ (847)
Outlays, Gross (Discretionary and Mandatory)	$ 116	$ 112
Distributed Offsetting Receipts	(625)	847
Agency Outlays, Net (Discretionary and Mandatory)	$ (509)	$ 959

The accompanying notes are an integral part of these financial statements.

Notes to the Investor Protection Fund Financial Statements

U.S. SECURITIES AND EXCHANGE COMMISSION

As of September 30, 2012 and 2011

NOTE 1. Significant Accounting Policies

A. Reporting Structure

The U.S. Securities and Exchange Commission (SEC) is an independent agency of the U.S. Government established pursuant to the Securities Exchange Act of 1934 (Exchange Act), charged with regulating this country's capital markets. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) established the Securities and Exchange Commission Investor Protection Fund. The Investor Protection Fund provides funding for a Whistleblower Award Program and finances the operations of the SEC Office of Inspector General's (OIG) Employee Suggestion Program. The Investor Protection Fund is a fund within the SEC, and these financial statements present a segment of the SEC's financial activity.

B. Basis of Presentation and Accounting

The accompanying financial statements present the financial position, net cost of operations, changes in net position, and budgetary resources of the Investor Protection Fund as required by Exchange Act Section 21F(g)(5). The Act requires a complete set of financial statements that includes a balance sheet, income statement, and cash flow analysis. The Investor Protection Fund is a Federal reporting entity. As such, its financial statements are prepared in conformity with generally accepted accounting principles (GAAP) for the Federal Government, and are presented in conformity with OMB Circular A-136, Financial Reporting Requirements. The legislative requirements to prepare an income statement and cash flow analysis are addressed by the Statement of Net Cost and Note 2, Fund Balance with Treasury, respectively.

The SEC's books and records serve as the source of the information presented in the accompanying financial statements.

The agency classifies assets, liabilities, revenues, and costs in these financial statements according to the type of entity associated with the transactions. Intragovernmental assets and liabilities are those due from or to other Federal entities, including those activities within the SEC. Intragovernmental revenues and costs result from transactions with other Federal entities.

The Balance Sheet, Statement of Net Cost and Statement of Changes in Net Position are prepared using the accrual basis of accounting. Accordingly, revenues are recognized when earned and expenses are recognized when incurred without regard to the receipt or payment of cash. These principles differ from budgetary accounting and reporting principles on which the Statement of Budgetary Resources is prepared. The statements may differ from other financial reports submitted pursuant to Office of Management and Budget (OMB) directives for the purpose of monitoring and controlling the use of budgetary resources, due to differences in applicable accounting and reporting principles discussed in the following paragraphs. Conceptually, the differences relate primarily to the capitalization and depreciation of property and equipment, as well as the recognition of other long-term assets and liabilities.

Certain prior year amounts presented on the Statement of Budgetary Resources and Required Supplementary Information have been reclassified to conform to the current year presentation required by OMB Circular A-136.

C. Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities. These estimates and assumptions include the disclosure of contingent liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

D. Intra- and Inter-Agency Relationships

Transactions with Other SEC Entities

The Investor Protection Fund is comprised of a single Federal Treasury Fund Symbol and has no intra-entity transactions. The Investor Protection Fund is the recipient of non-exchange revenues collected by the SEC and reported on the SEC's Statement of Custodial Activity. The Investor Protection Fund can finance the operations of the SEC Office of Inspector General's Employee Suggestion Program and the Office of the Whistleblower on a reimbursable basis.

Accounts receivable that may be used to fund the Investor Protection Fund are recognized as assets of the SEC. These resources are not assets of the Investor Protection Fund until the determination is made to deposit collections in the Investor Protection Fund.

Transactions with Other Federal Agencies

Whistleblower payments may be made from the Investor Protection Fund as a result of monetary sanctions paid to other Federal agencies in related actions, but only if there has been a Commission enforcement action resulting in sanctions of a million dollars or greater and the Commission has determined that the whistleblower is eligible for an award and recommended the percentage. In those instances, the SEC remains liable for paying the whistleblower. However, in instances where a whistleblower has already received an award from the Commodity Futures Trading Commission (CFTC), the whistleblower is not entitled to an award from the SEC.

E. Earmarked Fund

Earmarked funds are financed by specifically identified revenues, often supplemented by other financing sources, which remain available over time. Investor Protection Fund resources are earmarked and may only be used for the purposes specified by the Dodd-Frank Act.

F. Entity Assets

Assets that an agency is authorized to use in its operations are entity assets. The SEC is authorized to use all funds in the Investor Protection Fund for its operations. Accordingly, all assets are recognized as entity assets.

G. Fund Balance with Treasury

Fund Balance with Treasury reflects amounts the Investor Protection Fund holds in the U.S. Treasury that have not been invested in Federal securities. The SEC conducts all of its banking activity in accordance with directives issued by the U.S. Department of the Treasury's Financial Management Service.

H. Investments

The SEC has authority to invest amounts in the Investor Protection Fund in overnight and short-term, market-based Treasury securities. The interest earned on the investments is a component of the Fund and is available to be used for expenses of the Investor Protection Fund. Additional details regarding Investor Protection Fund investments are provided in *Note 3, Investments*.

I. Liabilities

The SEC records liabilities for probable future outflows or other sacrifices of resources as a result of events that have occurred as of the Balance Sheet date. Investor Protection Fund's liabilities consist of contingencies for potential whistleblower payments, amounts payable to whistleblowers, and reimbursable expenses that the Office of Inspector General incurs to operate the Employee Suggestion Program. There are no liabilities or contingent liabilities related to the Investor Protection Fund as of September 30, 2012 and 2011, respectively.

The Dodd-Frank Act and the SEC implementing regulations establish the eligibility criteria for whistleblower awards. Refer to *Note 4, Commitments and Contingencies* for information regarding the disclosure and recognition of actual and contingent liabilities for whistleblower awards.

J. Program Costs

The Investor Protection Fund reimburses the SEC's General Fund (X0100) for expenses incurred by the Office of Inspector General to administer the Employee Suggestion Program. The Investor Protection Fund also finances payments to whistleblowers under Section 21F of the Exchange Act.

K. Non-Exchange Revenue

Disgorgement and Penalty Transfers

Non-exchange revenue arises from the Government's ability to demand payment. The Investor Protection Fund is financed through the receipt of portions of monetary sanctions collected by the SEC in judicial or administrative actions brought by the SEC under the securities laws that are not either: (1) added to the disgorgement fund or other fund under Section 308 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7246) or (2) otherwise distributed to victims of a violation of the securities laws. The Investor Protection Fund recognizes non-exchange revenue for disgorgement and penalty amounts transferred into the fund from the SEC's Disgorgement and Penalties Fund (X6563). No sanction collected by the SEC can be deposited into the Investor Protection Fund if the balance in the fund exceeds $300 million on the day of collection.

Interest Earnings on Investments with Treasury

Interest earned from investments in U.S. Treasury securities is classified in the same way as the predominant source of revenue to the fund. The Investor Protection Fund is financed through the receipt of non-exchange revenues and thus interest earnings are also recognized as non-exchange revenues.

L. Budgets and Budgetary Accounting

The Investor Protection Fund (Fund X5567) is a special fund established through a permanent indefinite appropriation that has the authority to retain revenues and other financing sources not used in the current period for future use. The Dodd-Frank Act provides that the Fund is available to the SEC without further appropriation or fiscal year limitation for the purpose of paying awards to whistleblowers and funding the activities of the OIG's Employee Suggestion Program. However, the SEC is required to request and obtain an annual apportionment from OMB to use these funds.

The resources of the Investor Protection Fund are apportioned under Category B authority, which means that the funds represent budgetary resources distributed by a specified project and are not subject to quarterly apportionment. Thus, all obligations incurred as presented on the Statement of Budgetary Resources are derived from Category B funds.

NOTE 2. Fund Balance with Treasury

The Fund Balance with Treasury by type of fund and Status of Fund Balance with Treasury as of September 30, 2012 and 2011 consist of the following:

(DOLLARS IN THOUSANDS)	**FY 2012**	**FY 2011**
Fund Balances:		
Special Fund	$ 957	$ 73
Total Fund Balance with Treasury	$ 957	$ 73
Status of Fund Balance with Treasury:		
Unobligated Balance		
Available	$ 957	$ 73
Total Fund Balance with Treasury	$ 957	$ 73

Unobligated balances reported for the status of Fund Balance with Treasury do not agree with the amounts reported in the Statement of Budgetary Resources due to the fact that unobligated balances are not reduced when investments are purchased.

There were no differences between the Fund Balance reflected in the Investor Protection Fund financial statements and the balance in the Treasury accounts.

Cash flow

The Investor Protection Fund cash flows are reflected in investments and in the Statement of Budgetary Resources. Such cash flows during FY 2012 consisted of net investment redemptions of $375 thousand, net interest received of $625 thousand (which includes $4.2 million of interest collections and $3.6 million of premiums paid), payments to whistleblowers totaling $46 thousand, and the cost of operating the OIG Employee Suggestion Program of $70 thousand.

Cash flows during FY 2011 consisted of net investment purchases of $453.8 million (which includes $2 million of reinvested interest of the total $2.1 million interest received), and the cost of operating the OIG Employee Suggestion Program of $112 thousand.

NOTE 3. Investments, Net

The SEC invests funds in overnight and short-term non-marketable market-based Treasury bills. The SEC records the value of its investments in Treasury bills at cost and amortizes any premium or discount on a straight-line basis (S/L) through the maturity date of these securities. Non-marketable market-based Treasury securities are issued by the Bureau of Public Debt to Federal agencies. They are not traded on any securities exchange but mirror the prices of similar Treasury securities trading in the Government securities market.

At September 30, 2012, investments consisted of the following:

(DOLLARS IN THOUSANDS)	Cost	Amortization Method	Amortized (Premium) Discount	Interest Receivable	Investment, Net	Market Value Disclosure
Non-Marketable Market-Based Securities						
Investor Protection Fund – Entity	$ 454,119	S/L	$ (2,875)	$ 1,228	$ 452,472	$ 451,319

At September 30, 2011, investments consisted of the following:

(DOLLARS IN THOUSANDS)	Cost	Amortization Method	Amortized (Premium) Discount	Interest Receivable	Investment, Net	Market Value Disclosure
Non-Marketable Market-Based Securities						
Investor Protection Fund – Entity	$ 453,799	S/L	$ (2,314)	$ 1,230	$ 452,715	$ 451,696

Intragovernmental Investments in Treasury Securities

Market-based Treasury securities are debt securities that the U.S. Treasury issues to Federal entities without statutorily determined interest rates. Although the securities are not marketable, the terms (prices and interest rates) mirror the terms of marketable Treasury securities.

The Federal Government does not set aside assets to pay future benefits or other expenditures associated with the investment by Federal agencies in non-marketable Federal securities. The balances underlying these investments are deposited in the U.S. Treasury, which uses the cash for general Government purposes. Treasury securities are issued to the SEC as evidence of these balances. Treasury securities are an asset of the SEC and a liability of the U.S. Treasury. Because the SEC and the U.S. Treasury are both components of the Government, these assets and liabilities offset each other from the standpoint of the Government as a whole. For this reason, the investments presented by the SEC do not represent an asset or a liability in the U.S. Government-wide financial statements.

Treasury securities provide the SEC with authority to draw upon the U.S. Treasury to make future payments from these accounts. When the SEC requires redemption of these securities to make expenditures, the Government finances those expenditures out of accumulated cash balances, by raising taxes or other receipts, by borrowing from the public or repaying less debt, or by curtailing other expenditures. This is the same manner in which the Government finances all expenditures.

NOTE 4. Commitments and Contingencies

Commitments and Contingencies: Whistleblower Program

As mentioned in *Note 1.I, Liabilities*, the Investor Protection Fund is used to pay awards to whistleblowers if they voluntarily provide original information to the SEC and meet other conditions. The legislation allows whistleblowers to receive between 10 and 30 percent of the monetary sanctions collected in the covered action or in a related action, with the actual percentage being determined at the discretion of the SEC using criteria provided in the legislation and the related rules to implement the legislation adopted by the SEC.

A Preliminary Determination is a first assessment, made by the Claims Review Staff, as to whether the claim should be allowed or denied and, if allowed, what the proposed award percentage amount should be. A contingent liability is recognized in instances where a positive Preliminary Determination (payment of award is probable) has been made by the Claims Review Staff in the Office of the Whistleblower and the amount can be reasonably estimated. Liabilities are recognized in instances where a collection has been received and a positive Proposed Final Determination has been reached by the Claims Review Staff. However, the actual payment of the whistleblower award would not occur until after the final order was issued by the Commission.

The SEC did not recognize a contingent liability (not covered by budgetary resources) for potential whistleblower awards as of September 30, 2012. During FY 2012, the SEC made its first whistleblower award, paying the claimant $46 thousand. The payment amount was determined by applying the award percentage to the monetary sanctions actually collected in the covered action. If and when additional amounts are collected on the monetary sanction, additional amounts will be paid out to the claimant. The total potential whistleblower payments payable under this covered action are approximately $2.3 million. A contingent liability is not recorded for this action because future whistleblower payments are dependent on actual future cash collections which have yet to be determined.

NOTE 5. Intragovernmental Costs

The Statement of Net Cost presents the Investor Protection Fund's results of operations for its two activities: the Employee Suggestion Program and Payments to Whistleblowers. Intragovernmental costs arise from purchases of goods and services from other components of the Federal Government (including other SEC funds). In contrast, public costs are those which arise from the purchase of goods and services from non-Federal entities.

In FY 2012, the Employee Suggestion Program incurred $70 thousand of intragovernmental costs. The Payments to Whistleblowers incurred $46 thousand of costs with the public in FY 2012.

In FY 2011, the Employee Suggestion Program incurred $111 thousand of intragovernmental costs and $1 thousand of costs with the public.

NOTE 6. Status of Budgetary Resources

A. Explanation of Differences between the Statement of Budgetary Resources and the Budget of the U.S. Government

A comparison between the FY 2012 Statement of Budgetary Resources (SBR) and the actual FY 2012 data in the President's budget cannot be presented, as the FY 2014 President's budget which will contain FY 2012 actual data is not yet available; the comparison will be presented in next year's financial statements. There are no differences between the FY 2011 SBR and the FY 2011 data in the President's budget.

B. Other Budgetary Disclosures

There were no budgetary resources obligated for undelivered orders as of September 30, 2012 and 2011.

There are no legal arrangements affecting the use of unobligated balances of budget authority, such as time limits, purpose, and obligation limitations.

NOTE 7. Reconciliation of Net Cost of Operations to Budget

For the years ended September 30, 2012 and 2011, Obligations Incurred equaled the Net Cost of Operations and there were no reconciling items.

OTHER ACCOMPANYING INFORMATION

This section provides additional information regarding the SEC's financial and performance management. It includes a statement prepared by the agency's Office of Inspector General (OIG) summarizing what the OIG considers to be the most serious management and performance challenges facing the agency. The section also includes a response from the SEC's Chairman, outlining the agency's progress in addressing the challenges.

The Summary of Financial Statement Audit and Management Assurances clearly lists each material weakness and non-conformance found and/or resolved during the U.S. Government Accountability Office's (GAO) audit. Additionally, this section provides a detailed explanation of any significant erroneous payments, as required by the Improper Payments Information Act of 2002, as amended.

Inspector General's Statement on Management and Performance Challenges

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
INSPECTOR GENERAL

The Inspector General's Statement on the U.S. Securities and Exchange Commission's Management and Performance Challenges

Jon T. Rymer
Interim Inspector General
November 8, 2012 (revised)

The Reports Consolidation Act of 2000 requires the U.S. Securities and Exchange Commission (SEC), Office of Inspector General (OIG), to identify and report annually on the most serious management challenges the SEC faces. To identify management challenges we routinely review past and ongoing audit, investigation, and evaluation work to identify material weaknesses, significant deficiencies, and vulnerabilities. This statement has been compiled based on the work we have completed over the past year, our general knowledge of the SEC's operations, and feedback we received from the agency and the Government Accountability Office's (GAO) financial statement auditors.

MANAGEMENT AND PERFORMANCE CHALLENGES

Procurement and Contracting

Since fiscal year 2008, OIG has identified the SEC's procurement and contracting function as a management challenge. While we are pleased at the continued progress and improvements the Office of Acquisitions (OA) has made in this area, overall, procurement and contracting continues to be a management challenge.

Specifically, work conducted by OIG's Office of Investigations during the fiscal year revealed there were deficiencies in the SEC's administration of a personal services contract. On March 29, 2012, OIG issued a report of investigation into an allegation that the SEC had entered into an improper personal services contract. The investigation found evidence that an SEC contract may have been improperly administered because some contract personnel were subject to the continuous supervision and control of SEC employees.

According to the Federal Acquisition Regulation (FAR), a personal services contract is characterized by the employer-employee relationship that is created between the Government and the contractor's personnel. The Government is normally required to obtain its employees by direct hire under competitive appointment or other procedures that are required by the civil service laws. Obtaining personal services by contract, rather than by direct hire, circumvents these laws, absent a specific Congressional authorization.[1]

OIG's investigation recommended the agency obtain an opinion from the Comptroller General on whether the SEC was employing unauthorized personal services. However, we subsequently advised SEC management that issuing a new regulation on personal services contracts would be a sufficient response to the investigation's findings and a Comptroller General's opinion would not be needed.

While OA continues to make improvements in the procurement and contracting area, further progress is needed to ensure the SEC complies fully with the FAR provisions relating to personal services contracts.

Information Security

Though the Office of Information Technology (OIT) made significant improvements during the fiscal year, information security continues to be a management challenge for the SEC. This was further confirmed in the vulnerabilities that were identified in the system and network logs in the OIG's *Assessment of SEC Systems and Network Logs*, Report No. 500, issued March 16, 2012, and based on new weaknesses covering information security controls that GAO identified in its *Fiscal Year 2011 Audit of the SEC's Financial Statements* report.

In the *Assessment of SEC Systems and Network Logs* Report No. 500, OIG determined that OIT should identify capacity requirements for all servers, ensure sufficient capacity is available for the storage of audit records, configure auditing to reduce the likelihood that capacity will be exceeded, and implement a mechanism to alert and notify appropriate offices and divisions when log storage capacity is reached.

The report also found that many SEC servers did not log auditable events because their logging capacity had been exceeded. Further, the report found that there was no mechanism available to alert OIT's Servers and Storage Branch or OIT's Security Branch when servers reached their capacity and stopped performing logging functions. Most notably, the report revealed that decommissioned servers were still actively connected to the SEC's Enterprise networks and were still accessible.

Compliance with the Federal Information Security Management Act (FISMA) continues to be a management challenge for the SEC, due to repeat findings for the current and past fiscal years that have not been addressed. When taken as a whole, the combination of these deficiencies result in a management challenge

[1] FAR § 37.104(a).

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that must be addressed to ensure the SEC's full compliance with all FISMA requirements and the SEC's information technology (IT) framework is secured.

Specifically, in the *2011 FISMA Executive Summary Report*, Report No. 501, OIG issued February 2, 2012, we concluded that SEC risk management policy did not adhere to the requirements for a comprehensive governance structure and organization-wide risk management strategy and OIT's risk management did not address risk from a mission and business perspective as described in NIST SP 800-37, Rev 1, *Guide for Applying the Risk Management Framework to Federal Information Systems: A Security Life Cycle Approach*, February 2010.

Secondly, the SEC has not fully implemented baseline configurations and configuration compliance scanning within the information system environment. Baseline configurations have not been defined and configuration scanning is not conducted for networking devices. Without baseline or compliance scanning for networking devices, settings could be altered without the network administrator's knowledge. As a result, improperly configured devices could present an increased security risk to the SEC's systems.

In the *2011 FISMA Executive Summary Report*, OIT concurred with OIG's recommendation that the office complete its implementation of the technical solution for linking multi-factor authentication to Personal Identity Verification (PIV) cards for system authentication and require use of the PIV cards as a second authentication factor, but it still has not implemented a technical solution to link the multi-factor authentication solutions to SEC's PIV cards. Thus, the SEC is not in compliance with the requirements established in *Homeland Security Presidential Directive 12,* which opens the agency up to a higher risk for fraud, tampering, counterfeiting, etc.

Finally, the SEC's tailored set of baseline security controls are not explicitly defined in the System Security Plan (SSP) or other security documents for each system. Though OIT identifies a generic set of baseline security controls, the selection process is based on the security categorization of the system and is not in accordance with NIST SP 800-37, Rev 1. Additionally, OIT has not developed formal procedures that provide instructions for tailoring baseline security controls in compliance with NIST SP 800-53, Rev 3, *Recommended Security Controls for Federal Information Systems and Organizations,* August 2009. As a result of not implementing formal tailored control sets, a generic control set based only on security categorization could result in understating or overstating the security requirements for each system, and critical controls may not be identified for systems, if the tailoring process is not followed.

The areas discussed above remain challenges that were identified in the past and have not yet been completely mitigated. The OIG will continue its oversight of IT management and monitor progress in these areas.

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GAO reported in its fiscal year 2011 audit of the SEC's financial statements that the SEC made progress in strengthening its internal controls over its financial information systems. However, despite this progress, they identified new weaknesses in information security controls regarding

- incomplete implementation of SEC's information security program, and
- inadequate review of service auditors' reports that jeopardized the confidentiality and integrity of SEC's financial information.

Continuity of Operations Program

Federal agencies are required to have a viable Continuity of Operations Program (COOP) in place to ensure the agency can continue to perform its critical mission functions during an emergency. An agency's COOP plan focuses on restoring the organization's mission essential functions at an alternate site and performing these functions for up to 30 days before returning to normal operations.

The OIG has identified SEC's COOP as a management challenge. In the *Review of the SEC's Continuity of Operations Program*, Report No. 502, OIG issued on April 23, 2012, OIG identified areas needing improvement to ensure a comprehensive, cohesive, and up-to-date COOP that complies with Federal guidance. Many of the report's recommendations involve OIT's interaction with program offices and divisions agency-wide, to include the SEC's regional offices. These improvements were broadly separated into two groups:

(1) procedural problems, and
(2) IT equipment-related problems.

With regard to procedural improvements, the report found that supplemental plans for divisions, offices, and regional offices are not being updated or properly maintained. In addition, many of the plans that are in place contain unrealistic estimates of required recovery time. Further, the report found that several regional offices' Disaster Recovery Plans (DRP) had not been tested annually, and two regional offices did not include recovery phase testing in their most recent disaster recovery test plans. Finally, we found that while some OIT personnel regularly participate in DRP exercises, many essential personnel do not participate in these exercises and have not received appropriate role-based training for their part in the DRP and COOP activities.

Regarding IT equipment issues, our review identified instances where information feeds and power distribution throughout the SEC's network could fail if a disruption were to occur. In addition, equipment at the SEC's devolution sites is out-of-date and cannot be used with SEC's network due to unresolved security issues. We also found that remote access capabilities would be enhanced if remote access to desktop applications could function when the user's desktop computer is turned off or does not have power.

Among the report's 38 recommendations were that DRPs are tested thoroughly, each year and the SEC should revise its system recovery time objectives to include specific and realistic timeframes. Further, the report recommended that the SEC should take procedural steps such as categorizing essential personnel and ensure alternate worksites are readily accessible.

Financial Management

The GAO fiscal year 2011 audit of the SEC's financial statements[2] found that they were fairly presented in all material respects, in conformity with U.S. generally accepted accounting principles; and though internal controls could be improved, the SEC maintained, in all material respects, effective internal controls over financial reporting. Though GAO found no reportable noncompliance with the laws and regulations they tested, they identified four significant deficiencies in SEC's internal controls. The significant deficiencies identified during fiscal year 2011 included deficiencies in controls over

- information systems,
- financial reporting and accounting processes,
- budgetary resources, and
- registrant deposits and filing fees.

During the current fiscal year the SEC transitioned its core financial system to the Department of Transportation's Enterprise Service Center, Federal Shared Service Provider (FSSP). Based on the four significant deficiencies GAO identified in SEC's internal controls and the inherent risks that are associated with transitioning the SEC's core financial system to a FSSP, financial management remains a management challenge.

GAO found that the SEC continued to carry out its financial reporting during fiscal year 2011 using spreadsheets, databases, and data processing practices that relied on significant manual analysis, reconciliation, and work-arounds that were used to assist in calculating amounts in the general ledger transaction postings. Such manual processes are resource intensive and prone to error and, coupled with the significant amount of data involved, there is an increased risk of materially misstated account balances in the general ledger.

GAO reported that, consistent with prior audits, they continued to find deficiencies in SEC's recording of new obligations and monitoring of open obligations. These deficiencies resulted in misstatements in SEC's accounting records which could affect the reliability of information reported that is in its Statement of Budgetary Resources.

[2] Includes SEC's general purpose and Investor Protection Fund (IPF) financial statements.

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GAO also noted that the SEC made improvements in verifying current filing fee transactions more timely. However, they found continuing deficiencies in SEC's controls over registrant deposits and filing fees that collectively represented a significant deficiency for fiscal year 2011. Specifically, SEC has not effectively addressed previously reported deficiencies in its process to enable timely recognition of filing fee revenue. Because of this continuing control deficiency, SEC is not always recognizing filing fee revenue in the correct accounting period and, therefore, its registrant deposit liability could be misstated and not be corrected in a timely manner. Contributing to SEC's deficiencies in this area is that it has yet to finalize and implement a formal process for ongoing monitoring of filing fee transactions.

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Management's Response to Inspector General's Statement

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

November 14, 2012

Mr. Jon T. Rymer
Interim Inspector General
Office of Inspector General
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Mr. Rymer:

Thank you for your "Statement on the U.S. Securities and Exchange Commission's Management and Performance Challenges" issued on November 8, 2012. I appreciate your views and the perspective they provide on the issues facing the agency. We continue to focus on the challenges identified in your statement, as well as on a number of other initiatives to strengthen our operations and better protect investors. We also appreciate your acknowledgement of the important progress that the SEC has achieved during the past year. A brief description of the actions—already taken and planned to be taken—to address each of the challenges is provided below.

Procurement and Contracting

The Office of Acquisitions (OA) appreciates the Office of Inspector General's (OIG) recognition of the continued progress and improvement in the agency's approach to procurement and contracting. OA has worked diligently to address the OIG's concerns and has successfully addressed 20 OIG recommendations this past year.

We are deeply committed to rectifying this management challenge. During the course of FY 2012, we reorganized OA in concert with recommendations of an external consultant, hired new leadership both at the top and within the managerial ranks of the organization, and provided a significant amount of formal training to the staff. In addition, we have embarked on a number of business process improvements that we believe will further strengthen our competency in this domain.

With regard to the OIG's investigation of whether an expired contract was administered as a personal services contract, OA is developing a formal process for review of procurement actions for services as well as guidance on the administration of such contracts. These efforts will ensure inherently governmental functions will not be performed by contractors, that only non-personal service type contracts will be awarded, and that service contracts will be properly administered. The process will be implemented during the first quarter of FY 2013 and will consist of an SEC administrative regulation, operating procedures and a checklist. The OIG has provided useful comments on the draft procedures. Formal training will be provided in support

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of the new regulation. We have been collaborating closely with the OIG with regard to the development of our approach, and we appreciate their consultation.

Information Security

The SEC continued to strengthen its information security controls. During the year, the Office of Information Technology (OIT) implemented alerting mechanisms to notify SEC personnel when log capacity is approaching maximum capacity. In addition, OIT initiated a project to increase the centrally aggregated logging storage to properly retain log data. This effort is expected to enhance the agency's ability to cross-correlate events from multiple systems, and to enable the on-system storage to act as a redundant backup in the event of a log failure. OIT also reworked the decommissioning process to ensure all active systems connected to the SEC network are properly logging and those logs are being reviewed.

Ensuring the agency's full compliance with FISMA requirements remains a priority for the SEC. To that end, OIT is in the process of developing and implementing an agency-wide risk management strategy consistent with National Institute of Standards and Technology guidance. This effort is expected to be completed in FY 2013. The IT office also established official baselines for desktop operating systems in accordance with the USGCB (formerly FDCC) standard, as well as the SEC's five major server operating systems. Formal baselines for Oracle database server are on track for completion by the end of October 2012. Baseline configurations for network infrastructure devices, such as routers, switches and firewalls, are in process and expected to be completed in November 2012. Compliance scanning is scheduled to begin in November 2012 for both Oracle databases and network infrastructure devices. Finally, OIT is continuing efforts to link Personal Identity Verification cards to the SEC's logical access systems. This work is dependent on major upgrade projects such as the recently completed Windows 7 desktop migration and accompanying directory services migration. OIT expects to integrate logical access to Active Directory services controlled assets in December 2012.

Continuity of Operations

The SEC is committed to maintaining essential functions during an emergency and addressing areas identified by the OIG as needing improvement. To accomplish this, a comprehensive assessment of the SEC's COOP program is in progress. This assessment has required interaction with all SEC divisions and offices in order to update the agency's mission essential functions. The SEC's mission essential functions are the foundation of the COOP program and were developed following federal guidance.

Appropriate COOP staffing is fundamental to continuity of operations during an emergency. Given this, the SEC is reviewing and updating its list of mission essential employees and relocation teams to ensure that the appropriate decision-makers and support staff are ready to respond in an emergency. To support mission essential personnel during an emergency, a comprehensive continuity test, training, and exercise program has been developed. The SEC is working to provide staff with the equipment needed to carry out their duties from

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alternate locations during an emergency. In addition, the COOP program requires that staff regularly test equipment and remote access capabilities, as well as practice their emergency and continuity skills.

The SEC has actively incorporated the OIG's recommendations as a key component of the COOP program assessment process. A cross-organizational team has been established to manage procedural and information technology equipment-related problems. This team has resolved issues and modified COOP program components including: disaster recovery plans, recovery phase testing, power distribution, remote access capabilities when user desktop computers are turned off, and equipment security issues. The SEC is revising disaster recovery testing, implementing improvements to remote access testing, and addressing availability of equipment and systems in a continuity environment. In addition, OIT has reviewed the SEC's network and topology to verify the configuration so there are no single points of failure in the SEC architecture. The agency continues to make important progress and all COOP program OIG recommendations will be addressed by spring 2013.

Financial Management

In FY 2012, the SEC made significant progress in its multi-year effort to strengthen its internal controls over financial reporting. In spring 2012, the agency successfully transitioned its core financial system to a Federal Shared Service Provider (FSSP), the Department of Transportation's Enterprise Service Center (ESC). The SEC decided to implement the FSSP model in order to put its internal control posture on a more sustainable long-term footing, as well as to achieve specific internal control improvements. These include enhancements in system functionality, automation of some manual processes, and remediation of specific deficiencies noted in past financial audits.

Through this and other internal control enhancements, the SEC in FY 2012 made significant progress on each of the four significant deficiencies identified in 2011:

- <u>Financial accounting and reporting</u>: The SEC tightened controls over spreadsheets and cuff databases based upon risk. Further, the transition to the FSSP resulted in an automated interface between the procurement and financial systems, which has allowed the agency to eliminate its previously established manual reconciliation.

- <u>Information security</u>: As described more fully above, the SEC bolstered its continuous monitoring procedures over system access and implemented an enhanced risk management strategy. Further, security of the financial system has now transitioned to ESC, who routinely performs security updates and patching.

- <u>Registrant deposits and filing fees</u>: The SEC eliminated the backlog of registrant accounts that have seen no activity in the previous three years, and therefore are required to be returned to registrants or sent to the Treasury as unclaimed funds. Additional controls have also been put into place to monitor and review such accounts as they approach the three-year mark.

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- Budgetary resources: As mentioned above, the FSSP system features an automated interface between the procurement system and the financial system. Since previously obligations had to be entered manually in both systems, and therefore were subject to delays and errors, this automation is an important step forward. In addition, the agency continued to strengthen its processes for monitoring and de-obligating funds from completed contracts, and ensuring that appropriate accounting adjustments are recognized.

In FY 2013, the SEC will continue to focus resources on strengthening and enhancing its internal controls. The SEC's Office of Financial Management (OFM) has undergone an external organizational assessment, and will be implementing a new organizational structure, including the formalization of a function to regularly monitor transactional data. In addition, OFM will continue to optimize its processes under the FSSP model, in areas such as de-obligations of undelivered orders and proper recordation of property, plant, and equipment. The SEC is committed to investing the time and energy necessary to ensure that its internal controls over financial reporting are on a strong, sustainable path.

I hope that the actions outlined in this letter demonstrate our commitment to strengthening internal controls and improving the agency's performance. We look forward to working with you to further address these challenges.

Sincerely,

Mary L. Schapiro

Mary L. Schapiro
Chairman

Summary of Financial Statement Audit and Management Assurances

TABLE 3.1
SUMMARY OF FINANCIAL STATEMENT AUDIT

Audit Opinion: Unqualified

Restatement: No

Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Ending Balance
Total Material Weaknesses	—	—	—	—	—

TABLE 3.2
SUMMARY OF MANAGEMENT ASSURANCES

Effectiveness of Internal Control over Financial Reporting (FMFIA § 2)

Statement of Assurance: Unqualified

Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
Total Material Weaknesses	—	—	—	—	—	—

Effectiveness of Internal Control over Operations (FMFIA § 2)

Statement of Assurance: Unqualified

Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
Total Material Weaknesses	—	—	—	—	—	—

Conformance with Financial Management System Requirements (FMFIA § 4)

Statement of Assurance: Conformance

Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
Total Non-Conformances	—	—	—	—	—	—

Improper Payments Elimination and Recovery Act Reporting Details

The Improper Payments Information Act (IPIA) of 2002, as amended by the Improper Payments Elimination and Recovery Act (IPERA) of 2010, requires agencies to review all programs and activities they administer and identify those which may be susceptible to significant erroneous payments. For those programs and activities in which the risk of erroneous payments is identified as significant, agencies are required to estimate the amount of erroneous payments made in those programs annually.

The Office of Management and Budget (OMB) guidance provided in Circular A-136 and Appendix C of Circular A-123 require detailed information related to SEC's Improper Payments Elimination Program, which is outlined below.

Risk Assessment

In fiscal year (FY) 2012, the U.S. Securities and Exchange Commission (SEC) reviewed the programs and activities it administers to identify those which may be susceptible to significant erroneous payments. The risk assessment included 1) consideration of certain risk factors that are likely to contribute to a susceptibility to significant improper payments; and 2) transaction testing on a sampling of payments made during the first 10 months of FY 2012. The risk assessment was performed for the following programs:

- Vendor payments (includes travel and credit card payments);
- Disgorgement and penalty distributions (made by SEC to fund and tax administrators and directly to harmed investors); and
- Returned deposits of registration filing fees under Section 6b of the Securities Act of 1933 and Sections 13 and 14 of the Securities Exchange Act of 1934.

In April 2012, the SEC transitioned to a new financial system, hosted by a Federal Shared Service Provider (FSSP). Because of the change in the control environment, a supplemental risk assessment was conducted by reviewing a judgmentally selected sample of payments disbursed by the FSSP in each program during the period April 1, 2012 through July 31, 2012. The supplemental risk assessment provided a basis for determining if any activities and programs have become susceptible to significant erroneous payments under the new financial system and disbursement process.

Based on the results of transaction testing applied to a sample of payments, consideration of risk factors, and reliance on the internal controls in place over the payment, refund and distribution processes, the SEC determined that none of its programs and activities are susceptible to significant improper payments at or above the threshold levels set by OMB. Significant erroneous payments are defined as annual erroneous payments in the program exceeding both $10 million and 2.5 percent or $100 million of total annual program payments. In accordance with Appendix C of Circular A-123, the SEC is not required to determine a statistically valid estimate of erroneous payments or develop a corrective action plan if the program is not susceptible to significant improper payments.

In FYs 2007 and 2008, SEC's testing of its largest programs resulted in improper payment percentages that were well below one-half percent and less than $30,000 for each program. In FYs 2009, 2010, and 2011, the SEC performed a risk assessment for all programs and determined that its programs were not susceptible to significant erroneous payments.

Since the level of risk in each program is determined to be low and baseline estimates have been established, the SEC is only required to conduct a formal risk assessment every three years unless the program experiences a significant change in legislation and/or a significant increase in funding level. The SEC will conduct a follow-on review in FY 2013 of its programs and activities to determine whether the programs have experienced any unexpected changes in legislation or funding levels. If so, the SEC will re-assess the programs' risk susceptibility and make a statistically valid estimate of erroneous payments for any programs determined to be susceptible to significant erroneous payments.

Recapture of Improper Payments

The SEC does not administer grant, benefit or loan programs. Implementation of recapture auditing, if determined to be cost-effective, would apply to vendor payments, disgorgement and penalty distributions, and refunds of registration filing fee deposits. Because the definition of payment in the IPERA legislation is any payment or transfer of Federal funds to any non-Federal person or entity, the SEC is not required to review, and has not reviewed, intragovernmental transactions and payments to employees.

The SEC has determined that implementing a payment recapture audit program for vendor payments, disgorgement and penalty distributions, and refunds of registration filing fee deposits is not cost-effective. That is, the benefits or recaptured amounts associated with implementing and overseeing the program do not exceed the costs, including staff time or payments to a contractor, for implementation of a payment recapture audit program. In making this determination, the SEC considered its low improper payment rate based on testing conducted over the past five years. The SEC further considered whether sophisticated software and other cost-efficient matching techniques could be used to identify significant overpayments at a low cost per overpayment, or if labor intensive manual reviews of paper documentation would be required. Additionally, the SEC considered the availability of other tools that could efficiently perform the payment recapture audit and minimize payment recapture audit costs.

The SEC will continue to monitor improper payments across all programs and activities it administers and assess whether implementing payment recapture audits for each program is cost-effective. If future risk assessments determine a program is susceptible to significant improper payments and implementing a payment recapture program is cost-beneficial, the SEC will implement a pilot payment recapture audit to measure the likelihood of cost-effective payment recapture audits on a larger scale.

Even though the SEC has determined that implementing a payment recapture audit program for its programs is not cost-effective, the agency strives to recover any overpayments identified through other sources, such as payments identified through statistical samples conducted under IPIA. The amounts identified and recovered, by program, are shown in Table 3.3 below.

TABLE 3.3

OVERPAYMENTS RECAPTURED OUTSIDE OF PAYMENT RECAPTURE AUDITS *(IN DOLLARS)*

Source	Amount Identified (CY)	Amount Recovered (CY)	Amount Identified (PYs)	Amount Recovered (PYs)	Cumulative Amount Identified (CY+PYs)	Cumulative Amount Recovered (CY+PYs)
Vendor Payments						
Improper Payments Sampling	$ 810.01	$ 329.00	$12,762.85	$12,755.86	$13,572.86	$13,084.86
Disgorgement and Penalty Distributions						
Improper Payments Sampling	$ —	$ —	$ —	$ —	$ —	$ —
Refunds of Registration Filing Fee Deposits						
Improper Payments Sampling	$ 321.15	$ 321.15	$ —	$ —	$ 321.15	$ 321.15

Appendix A: Chairman and Commissioners

Mary L. Schapiro

CHAIRMAN

Mary L. Schapiro is the 29th Chairman of the U.S. Securities and Exchange Commission. Chairman Schapiro was appointed by President Barack Obama on January 20, 2009, unanimously confirmed by the U.S. Senate, and sworn in on January 27, 2009. She is the first woman to serve as the agency's permanent Chairman.

Over the course of Chairman Schapiro's tenure, the SEC has brought a record number of enforcement actions; pursued scores of individuals and entities in connection with the financial crisis; put in place a series of measures to help reduce the likelihood of another flash crash; obtained significant responsibilities for derivatives, hedge funds and credit rating agencies as a result of financial reform legislation; and undertaken a comprehensive restructuring that has significantly increased the SEC's effectiveness in support of its investor protection mission.

Prior to becoming SEC Chairman, Chairman Schapiro was CEO of the Financial Industry Regulatory Authority (FINRA) — the largest non-governmental regulator for all securities firms doing business with the U.S. public. Chairman Schapiro joined the organization in 1996 as President of NASD Regulation. In 2006, she was named NASD's Chairman and CEO. The following year, she led the organization's consolidation with NYSE Member Regulation to form FINRA.

In 1994, Chairman Schapiro was appointed by President Bill Clinton as Chairman of the Commodity Futures Trading Commission, a position she held until joining NASD.

Chairman Schapiro has received appointments to the Commission from four presidents. She was first appointed as a commissioner by President Ronald Reagan in 1988 and was re-appointed by President George H.W. Bush the following year, before being named acting Chairman by President Clinton in 1993.

A 1977 graduate of Franklin and Marshall College in Lancaster, Pennsylvania, Chairman Schapiro earned a Juris Doctor degree (with honors) from George Washington University in 1980.

Elisse B. Walter
COMMISSIONER

Elisse B. Walter was appointed by President George W. Bush to the U.S. Securities and Exchange Commission and sworn in on July 9, 2008. Under designation by President Barack Obama, she served as Acting Chairman during January 2009.

Prior to her appointment as an SEC Commissioner, Ms. Walter served as Senior Executive Vice President, Regulatory Policy & Programs, for FINRA. She held the same position at NASD before its 2007 consolidation with NYSE Member Regulation.

Ms. Walter coordinated policy issues across FINRA and oversaw a number of departments including Investment Company Regulation, Member Education and Training, Investor Education, and Emerging Regulatory Issues. She also served on the Board of Directors of the FINRA Investor Education Foundation.

Prior to joining NASD, Ms. Walter served as the General Counsel of the Commodity Futures Trading Commission. Before joining the CFTC in 1994, Ms. Walter was the Deputy Director of the Division of Corporation Finance of the Securities and Exchange Commission. She served on the SEC's staff beginning in 1977, both in that division and in the Office of the General Counsel. Before joining the SEC, Ms. Walter was an attorney with a private law firm.

Ms. Walter is a member of the Academy of Women Achievers of the YWCA of the City of New York and the inaugural class of the ABA's DirectWomen Institute. She also has received, among other honors, the Presidential Rank Award (Distinguished), the SEC Chairman's Award for Excellence, the SEC's Distinguished Service Award, and the Federal Bar Association's Philip Loomis and Manuel F. Cohen Younger Lawyer Awards.

She graduated from Yale University with a B.A., cum laude, in mathematics and received her J.D. degree, cum laude, from Harvard Law School. Ms. Walter is married to Ronald Alan Stern, and they have two sons, Jonathan and Evan.

Luis A. Aguilar
COMMISSIONER

Luis A. Aguilar is a Commissioner at the U.S. Securities and Exchange Commission. He was sworn in on July 31, 2008. Commissioner Aguilar was appointed by President George W. Bush and was reappointed by President Barack Obama in 2011.

Prior to his appointment, his practice included matters pertaining to general corporate and business law, international transactions, investment companies and investment advisers, securities law, and corporate finance. He also focused on issues related to corporate governance, public and private offerings (IPOs and secondary offerings), mergers and acquisitions, mutual funds, investment advisers, broker-dealers, and other aspects of federal and state securities laws and regulations.

Commissioner Aguilar represents the Commission as its liaison to both the North American Securities Administrators Association (NASAA) and to the Council of Securities Regulators of the Americas (COSRA).

Commissioner Aguilar has received various honors and awards, including: recipient of the Atlanta Falcons "2012 NFL Hispanic Heritage Leadership Award" (2012); named by Poder.Hispanic Magazine as one of the "100 Most Influential Hispanics in the Nation" (2011); named by Latino Leaders Magazine as one of the "Top 101 Most Influential Latinos in the United States" (2009, 2010, 2011 and 2012); named to the NACD Directorship 100, the Who's Who of the Boardroom (2009, 2010 and 2011); recipient of The Center for Accounting Ethics, Governance, and the Public Interest "Accounting in the Public Interest Award" (2010); listed in Best Lawyers in America (2005, 2006, 2007 and 2008); and named as one of "Georgia's Super Lawyers," as published in Atlanta Magazine and Georgia Super Lawyers Magazine (2004, 2005, 2006 and 2008).

He is a graduate of the University of Georgia School of Law, and also received a master of laws degree in taxation from Emory University. Additionally, he has successfully completed Series 7, 24, 63, and 65 examinations in connection with serving as president and a director of a registered broker-dealer. Commissioner Aguilar has also written numerous articles over the years.

Commissioner Aguilar serves as sponsor of the SEC's Hispanic Employment Committee, the African American Council, and the Caribbean American Heritage Committee.

Troy A. Paredes

COMMISSIONER

Commissioner Paredes was appointed by President George W. Bush to the U.S. Securities and Exchange Commission and sworn in on August 1, 2008.

Before joining the SEC, Commissioner Paredes was a tenured professor at Washington University School of Law in St. Louis, Missouri. He also held a courtesy appointment at Washington University's Olin Business School.

While a professor, Commissioner Paredes made presentations around the country on securities law and corporate governance, and he served as an expert on various legal matters. In addition, he has researched numerous topics such as executive compensation; hedge funds; private placements; the allocation of control within firms among directors, officers, and shareholders; the psychology of corporate and regulatory decision making; behavioral finance; alternative methods of regulation and market-based approaches to corporate accountability and securities regulation; comparative corporate governance, including the development of corporate governance and securities law systems in emerging markets; and the law and business of commercializing innovation. His scholarly work, among other things, has advocated for rigorous cost-benefit analysis when regulating and emphasized the need for accessible and understandable disclosures that investors can use effectively.

As a professor, Commissioner Paredes has authored many articles, and he is also a co-author (beginning with the 4th edition) of a multi-volume securities regulation treatise with Louis Loss and Joel Seligman, entitled *Securities Regulation*.

Before joining the Washington University faculty in 2001, Commissioner Paredes practiced law at prominent national law firms. As a practicing lawyer, he worked on a variety of transactions and legal matters involving financings, mergers and acquisitions, and corporate governance.

He graduated from the University of California at Berkeley with a bachelor's degree in economics in 1992. He went on to graduate from Yale Law School in 1996.

Daniel M. Gallagher

COMMISSIONER

Commissioner Gallagher was confirmed by the Senate on October 21, 2011, and returned to the Securities and Exchange Commission, where he had previously served, on November 7, 2011.

Commissioner Gallagher was on the staff of the SEC beginning in January 2006, when he served as a counsel to SEC Commissioner Paul S. Atkins and later as a counsel to SEC Chairman Christopher Cox. He worked primarily on major matters before the Commission involving the Division of Trading and Markets and the Division of Enforcement.

He joined the Division of Trading and Markets as a Deputy Director in 2008, where he played a key role in the SEC's response to the financial crisis and other significant issues before the Commission, including those involving credit rating agencies and credit default swaps. He served as an Acting Director of the Trading and Markets Division from April 2009 to January 2010, after which he left the agency to become a partner in the Washington D.C. office of WilmerHale.

Prior to his initial SEC service, Commissioner Gallagher was the General Counsel and Senior Vice President of Fiserv Securities, Inc., where he was responsible for managing all of the firm's legal and regulatory matters. Commissioner Gallagher began his career in private practice, advising clients on broker-dealer regulatory issues and representing clients in SEC and SRO enforcement proceedings.

Commissioner Gallagher earned his JD degree, magna cum laude, from the Catholic University of America, where he was a member of the law review. He graduated from Georgetown University with a BA degree in English.

Appendix B: Major Enforcement Cases

Introduction

In order to help protect investors and maintain fair markets, the U.S. Securities and Exchange Commission (SEC) brings enforcement actions against individuals and organizations for alleged securities laws violations. As the SEC's largest division, the Division of Enforcement investigates potential violations of the Federal securities laws and brings civil charges in Federal district court and administrative proceedings. Through the Division of Enforcement, the Commission stops fraud, seeks appropriate penalties and disgorgement from wrongdoers, and returns funds to injured investors. Successful enforcement actions also result in orders barring wrongdoers from working in the securities industry. In fiscal year (FY) 2012, the Division of Enforcement utilized its increased specialization and expertise as well as the creativity and doggedness of its staff to bring the second highest number of enforcement actions ever filed in a single year. These actions spanned the full spectrum of securities laws violations. This performance comes just two years after the most significant structural reforms in the Division's history. This section outlines the major enforcement cases of FY 2012. For further information on selected enforcement cases, please see "Litigation Releases" at *http://www.sec.gov/litigation/litreleases.shtml*.

Actions Related to the Financial Crisis

Building on its strong record in this area, a high priority of the SEC in FY 2012 continued to be identifying and holding accountable those individuals and institutions whose misconduct led to or arose from the financial crisis. To date, the SEC has filed 79 enforcement actions involving wrongdoing generally associated with the financial crisis, including: (a) concealing from investors risks, terms, and improper pricing of collateralized debt obligations (CDOs) and other complex structured products; (b) misleading disclosures to investors about mortgage-related risks; and (c) concealing the extent of risky mortgage-related and other high-risk investments in mutual funds and other financial products. In FY 2012, the SEC filed 29 such actions, representing a 26 percent increase over FY 2011.

In total, the SEC's financial crisis related cases have resulted in charges against 117 individuals and entities, including 57 Chief Executive Officers (CEOs), Chief Financial Officers (CFOs), and other senior corporate officers. These cases have resulted in more than $2.2 billion of monetary relief being ordered or agreed to, most of which has been or is in the process of being returned to harmed investors. In addition, 36 individuals have been barred from the securities industry, from serving as officers and directors of public companies, and/or from appearing or practicing before the Commission.

The major financial crisis actions filed in FY 2012 include a pair of cases against the six former top executives of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) for misleading statements regarding the extent of each company's holdings of higher-risk mortgage loans, including subprime loans.[1] The three former Fannie Mae executives charged were former CEO Daniel H. Mudd, former Chief Risk Officer Enrico Dallavecchia, and former Executive Vice President of Fannie Mae's Single Family Mortgage business, Thomas A. Lund. The former Freddie Mac executives charged were former Chairman of the Board and CEO Richard F. Syron, former Executive Vice President and Chief Business Officer Patricia L. Cook, and former Executive Vice President for the Single Family Guarantee business, Donald J. Bisenius. The SEC's complaint against the former Fannie Mae executives alleges that, when Fannie Mae began reporting its exposure to subprime loans in 2007, it broadly described the loans as those "made to borrowers with weaker credit histories," and then reported — with the knowledge, support, and approval of Mudd, Dallavecchia, and Lund — less than one-tenth of its loans that met that description. Similarly, the complaint against the former Freddie Mac executives alleges that they led investors to believe that the firm, using a broad definition of "subprime" loans, was disclosing all of its subprime loan exposure. Unbeknownst to investors, Freddie Mac had far more subprime exposure than it had disclosed in its SEC filings. The litigated actions against the former Fannie Mae and Freddie Mac executives are ongoing.

1 *SEC v. Daniel H. Mudd, et al., and SEC v. Richard F. Syron, et al., Lit. Rel. No. 22201 (December 20, 2011) http://www.sec.gov/litigation/litreleases/2011/lr22201.htm*

In another action, the SEC charged four former investment bankers and traders at Credit Suisse Group for engaging in a complex scheme to fraudulently overstate the prices of $3 billion in subprime bonds during the height of the financial crisis.[2] These individuals, including Kareem Serageldin, Credit Suisse's former global head of strategic credit, deliberately ignored specific market information showing a sharp decline in the price of the subprime bonds and, instead, marked them in a way that allowed Credit Suisse to achieve fictional profits. The defendants marked the bonds to hit daily and monthly profit targets, cover up losses in other trading books, and send a message to senior management about their group's profitability. The mispricing scheme was motivated in part by the investment bankers' desire for lavish year-end bonuses and, in the case of Serageldin, a promotion into the senior-most echelon of Credit Suisse's investment banking unit. The action against Serageldin is ongoing; the remaining defendants settled.

In FY 2012, the SEC filed several actions charging bank and mortgage executives for misleading investors about mounting loan losses and the deteriorating financial condition at their institutions. In October 2011, the SEC charged four former executives of California-based United Commercial Bank, including former CEO Thomas Wu, with misleading investors about the size of the bank's loan losses during the height of the financial crisis in 2008 and 2009.[3] The SEC's complaint alleges that Wu, along with the bank's former Chief Operating Officer (COO) and another senior executive, delayed the proper recording of loan losses and concealed these losses from the bank's auditors, causing the bank's public holding company to understate 2008 operating losses by at least $65 million. When the company filed its 2008 financial statements, Wu and the other defendants were aware of significant losses on several large loans, including that the loans had dramatically reduced property appraisals and, in some instances, were secured by worthless collateral. Rather than disclose the loan losses, Wu and the defendants repeatedly hid this information from UCBH's auditors and investors. Continued declines in the value of the bank's loans and other assets resulted in the bank's failure and the appointment of the Federal Deposit Insurance Corporation as receiver. United Commercial Bank was one of the 10 largest bank failures during the financial crisis. The defendants are litigating the SEC's claims.

In a similar action, the SEC charged three former executives of Lincoln, Nebraska-based TierOne Bank for participating in a scheme to understate millions of dollars in losses and mislead investors and Federal regulators at the height of the financial crisis.[4] The SEC alleges that Gilbert G. Lundstrom, who was the CEO and Chairman of the Board at TierOne, along with president and COO James A. Laphen and Chief Credit Officer Don A. Langford, played a role in TierOne understating its loan-related losses as well as losses on real estate repossessed by the bank. As a result of TierOne expanding into riskier lending in certain high-growth geographic areas, the bank experienced a significant rise in high-risk problem loans. TierOne's primary Federal banking regulator directed it to maintain higher capital ratios due to the bank's increase in high-risk problem loans. To appear to comply with the heightened capital requirements, Lundstrom, Laphen, and Langford disregarded information showing that the collateral securing certain loans and real estate repossessed by the bank was overvalued due to TierOne's reliance on stale and inadequately discounted appraisals. The losses were understated by millions of dollars in multiple SEC filings. Lundstrom and Laphen settled the SEC's claims, while Langford is litigating the claims filed against him.

In another action, the SEC charged the three senior-most executives at Thornburg Mortgage Inc., formerly one of the nation's largest mortgage companies, with hiding the company's deteriorating financial condition at the onset of the financial crisis.[5] The SEC's complaint alleges that Thornburg's CEO Larry Goldstone, CFO Clarence Simmons, and Chief Accounting Officer Jane Starrett schemed to fraudulently overstate the company's income by more than $400 million and falsely record a profit rather than an actual loss for the fourth quarter in its 2007 annual report. Behind the scenes,

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[2] *SEC v. Kareem Serageldin, et al., Lit. Rel. No. 22247 (February 1, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22247.htm*

[3] *SEC v. Thomas S. Wu, et al., Lit. Rel. No. 22121 (October 11, 2012) http://www.sec.gov/litigation/litreleases/2011/lr22121.htm*

[4] *SEC v. Gilbert G. Lundstrom, et al., and SEC v. Don A. Langford, Lit. Rel. No. 22493 (September 25, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22493.htm*

[5] *SEC v. Larry Goldstone, et al., Lit. Rel. No. 22287 (March 13, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22287.htm*

Thornburg was facing a severe liquidity crisis and was unable to make on-time payments for substantial margin calls it received from its lenders in the weeks leading up to the filing of its annual report on February 28, 2008. By the time the company filed an amended annual report, its stock price had collapsed by more than 90 percent. Thornburg never fully recovered and filed for bankruptcy on May 1, 2009. The case against the three executives is continuing.

In April, the SEC charged the former CEO and former CFO of Franklin Bank Corp. for their involvement in a fraudulent scheme designed to conceal the deterioration of the bank's loan portfolio and inflate its reported earnings during the financial crisis.[6] The complaint alleges that the former executives used aggressive loan modification programs during the third and fourth quarters of 2007 to hide the true amount of Franklin's non-performing loans and artificially boost its net income and earnings. The schemes concealed more than $11 million in non-performing single-family residential loans and $13.5 million in non-performing residential construction loans, resulting in overstatements in Franklin's third-quarter 2007 net income and earnings. Franklin declared bankruptcy in 2008. The case against the two former executives is continuing.

In another subprime mortgage case, the SEC charged H&R Block subsidiary Option One Mortgage Corporation with misleading investors in several offerings of subprime residential mortgage-backed securities by failing to disclose that its financial condition was significantly deteriorating.[7] In particular, Option One promised investors in more than $4 billion worth of RMBS offerings that it sponsored in early 2007 that it would repurchase or replace mortgages that breached representations and warranties. Option One, however, failed to tell investors about its deteriorating financial condition and that it could not meet its repurchase obligations on its own. Option One paid $28.2 million to settle the SEC's charges.

In a significant action related to mutual funds, the SEC charged investment management company OppenheimerFunds Inc. and its sales and distribution arm with making misleading statements about two of its mutual funds struggling in the midst of the financial crisis.[8] Oppenheimer used derivative instruments known as total return swaps (TRS contracts) to add substantial commercial mortgage-backed securities (CMBS) exposure in a high-yield bond fund called the Oppenheimer Champion Income Fund and an intermediate-term, investment-grade fund called the Oppenheimer Core Bond Fund. The 2008 prospectus for the Champion Fund didn't adequately disclose the fund's practice of assuming substantial leverage in using derivative instruments. When declines in the CMBS market triggered large cash liabilities on the TRS contracts in both funds and forced Oppenheimer to reduce CMBS exposure, Oppenheimer disseminated misleading statements about the funds' losses and their recovery prospects. Oppenheimer paid more than $35 million to settle the SEC's charges.

The SEC continued to charge misconduct related to CDOs and other complex structured products. In July, the SEC charged the U.S. investment banking subsidiary of Japan-based Mizuho Financial Group and three former employees with misleading investors in a CDO by using "dummy assets" to inflate the deal's credit ratings.[9] The SEC also charged the firm that served as the deal's collateral manager and its portfolio manager.[10] Mizuho structured and marketed Delphinus CDO 2007-1, a CDO that was backed by subprime bonds at a time when the housing market was showing signs of severe distress. The deal was contingent upon Mizuho obtaining credit ratings it used to market the notes to investors. When its employees realized that Delphinus could not meet one rating agency's newly announced criteria intended to protect CDO investors from the uncertainty of ratings downgrades, they submitted to the rating firm a portfolio

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[6] *SEC v. Anthony J. Nocella, et al., Lit. Rel. No. 22321 (April 6, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22321.htm*

[7] *SEC v. Option One Mortgage Corporation, Lit. Rel. No. 22344 (April 24, 2012) http://www.sec.gov./litigation/litreleases/2012/lr22344.htm*

[8] *In the Matter of OppenheimerFunds, Inc., et al., Exchange Act Rel. No. 67142 (June 6, 2012) http://www.sec.gov/litigation/admin/2012/33-9329.pdf*

[9] *SEC v. Mizuho Securities USA Inc., Lit. Rel. No. 22417 (July 19, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22417.htm; In the Matter of Alexander V. Rekeda, Exchange Act Rel. No. 67455 (July 18, 2012) http://www.sec.gov/litigation/admin/2012/33-9340.pdf; In the Matter of Xavier Capdepon, et al., Exchange Act Rel. No. 67456 (July 18, 2012) http://www.sec.gov/litigation/admin/2012/33-9341.pdf*

[10] *In the Matter of Delaware Asset Advisers, et al., Securities Act Rel. No. 9339 (July 18, 2012) http://www.sec.gov/litigation/admin/2012/33-9339.pdf*

containing millions of dollars in dummy assets that inaccurately reflected the collateral held by Delphinus. Once the firm rated the inaccurate portfolio, Mizuho closed the transaction and sold the notes to investors using the misleading ratings. Delphinus defaulted in 2008 and eventually was liquidated in 2010. Mizuho paid $127.5 million to settle the SEC's charges, and the others charged also settled the SEC's actions against them.

In FY 2012, the SEC also secured significant victories and settlements in previously filed financial crisis enforcement actions. In March, the SEC announced that a Federal judge ordered the former CEO of Brookstreet Securities Corp., Stanley C. Brooks, to pay a maximum $10 million penalty related to the fraud action that the SEC filed against Brooks for systematically selling risky mortgage-backed securities during the financial crisis to customers with conservative investment goals.[11] In September, the SEC settled charges with investment advisory firm ICP Asset Management and its founder and president Thomas C. Priore regarding allegations of fraud related to misrepresentations that caused the CDOs they managed to overpay for securities.[12] In addition, the SEC alleged that Priore and ICP improperly obtained fees and undisclosed profits at the expense of the CDOs and their investors. ICP and Priore paid more than $23 million to settle the case. Priore also agreed to be barred from working in the securities industry for five years.

Actions Related to Exchanges, Broker-Dealers, and Market Structure Issues

The Commission brought several actions in FY 2012 for compliance failures and rules violations relating to stock exchanges, alternative trading platforms, and other market structure participants. In October, the SEC sanctioned two electronic stock exchanges and a broker-dealer owned by Direct Edge Holdings LLC for violations arising out of weak controls that resulted in millions of dollars in trading losses and a systems outage.[13] In one incident on November 8, 2010, untested computer code changes resulted in two electronic stock exchanges affiliated with Direct Edge overfilling orders submitted by three members, resulting in unwanted trades involving an estimated 27 million shares in about 1,000 stocks, and totaling $773 million. To resolve the overfilled trades, the exchanges assumed and traded out of the overfilled shares in violation of their own rules and the Commission's rules on short selling. In the second incident on April 13, 2011, one of the electronic exchange's database administrators inadvertently disabled database connections, disrupting the exchange's ability to process incoming orders, modifications, and cancellations, and leading several of the exchange's members to file claims for more than $668,000 in losses. The exchange received internal alerts immediately and got external notifications soon after, including from members seeking to cancel unfilled trades and from numerous trading centers that were bypassing the exchange because it wasn't responding immediately to incoming orders. The exchange waited approximately 24 minutes after the outage to remove its quotations from public market data, and violated the SEC's Regulation NMS by failing to immediately identify its quotations as manual quotations. The SEC censured Direct Edge and its affiliated exchanges and ordered Direct Edge to undertake significant remedial actions.

That same month, the SEC charged Pipeline Trading Systems and two of its top executives with failing to disclose to customers of Pipeline's "dark pool" trading platform that the vast majority of orders were filled by a trading operation affiliated with Pipeline.[14] Pipeline was registered with the SEC as an alternative trading system, a privately operated platform to trade securities outside of traditional exchanges. Alternative trading systems that display little or no information about customer orders are known as "dark pools." Pipeline described its trading platform as a "crossing network" that matched customer orders with those from other customers, providing "natural liquidity." Pipeline's claims were false and misleading because its parent company owned a trading

[11] *SEC v. Brookstreet Securities Corp., et al., Lit. Rel. No. 22277 (March 6, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22277.htm*

[12] *SEC v. ICP Asset Mgmt., LLC, et al., Lit. Rel. No. 22477 (September 10, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22477.htm*

[13] *In the Matter of EDGX Exchange, Inc., et al., Exchange Act Rel. No. 65556 (October 13, 2011) http://www.sec.gov/litigation/admin/2011/34-65556.pdf*

[14] *In the Matter of Pipeline Trading Systems LLC, et al., Exchange Act Rel. No. 65609 (October 24, 2011) http://www.sec.gov/litigation/admin/2011/33-9271.pdf*

entity that filled the vast majority of customer orders on Pipeline's system. Although Pipeline took certain steps to address the conflict of interest it created, including by rewarding its affiliate's traders for giving favorable prices to Pipeline's customers, Pipeline nevertheless violated the Federal securities laws by failing to disclose the affiliate's activities to Pipeline's investors. Pipeline settled with the SEC by paying a $1 million penalty and the two executives settled by paying penalties of $100,000 each.

In late January, the SEC charged a trader in Latvia for conducting a widespread online account intrusion scheme in which he manipulated the prices of more than 100 NYSE and Nasdaq securities and caused more than $2 million in harm to customers of U.S. brokerage firms.[15] The SEC also instituted related administrative proceedings against four electronic trading firms and eight executives charged with enabling the trader's scheme by allowing him anonymous and unfiltered access to the U.S. markets.[16] According to the SEC's complaint, Igors Nagaicevs broke into online brokerage accounts of customers at large U.S. broker-dealers and drove stock prices up or down by making unauthorized purchases or sales in the hijacked accounts. This occurred on more than 150 occasions over the course of 14 months. Nagaicevs – using the direct, anonymous market access provided to him by various unregistered firms – traded those same securities at artificial prices and reaped more than $850,000 in illegal profits.

In another case, the SEC charged Chicago-based options-Xpress, an online brokerage and clearing agency specializing in options and futures, as well as its former CFO and a customer involved in an abusive naked short selling scheme.[17] The firm failed to satisfy its close-out obligations under Regulation SHO by repeatedly engaging in a series of sham "reset" transactions designed to give the illusion that the firm had purchased securities of like kind and quantity. The firm's customer engaged in these sham reset transactions in a number of securities, resulting in continuous failures to deliver. Regulation SHO requires the delivery of equity securities to a registered clearing agency when delivery is due, generally three days after the trade date. If no delivery is made by that time, the firm must purchase or borrow the securities to close out the failure-to-deliver position by no later than the beginning of regular trading hours on the next day. The sham reset transactions impacted the market for the issuers. For example, from Jan. 1, 2010 to Jan. 31, 2010, optionsXpress customers accounted for an average of 47.9 percent of the daily trading volume in one of the securities. In 2009 alone, the optionsXpress customer accounts engaging in the activity purchased approximately $5.7 billion worth of securities and sold short approximately $4 billion of options. According to the SEC's order, by engaging in the alleged misconduct, optionsXpress violated Regulation SHO and caused and willfully aided and abetted the customers' violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rules 10b-5 and 10b-21 thereunder. The SEC also separately charged three other optionsXpress officials – the head of trading and customer service and two compliance officers – all of whom settled the charges against them for their roles in the scheme.[18]

In September, the SEC brought first-of-its-kind charges against the New York Stock Exchange for compliance failures that gave certain customers an improper head start on trading information.[19] According to the SEC's order, NYSE violated Regulation NMS, which prohibits the practice of improperly sending market data to proprietary customers before broadly distributing trade and quote data to the public, over an extended period of time beginning in 2008 by sending data through two of its proprietary feeds before sending data to the consolidated feeds. NYSE's inadequate compliance efforts failed to monitor the speed of its proprietary feeds compared to its data transmission to the consolidated feeds. NYSE and its parent company, NYSE Euronext,

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[15] *SEC v. Igors Nagaicevs, Lit. Rel. No. 22238 (January 26, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22238.htm*

[16] *In the Matter of Alchemy Ventures, Inc., et al., Exchange Act Rel. No. 66249 (January 26, 2012) http://www.sec.gov/litigation/admin/2012/34-66249.pdf*

[17] *In the Matter of optionsXpress, Inc., et al. Exchange Act Rel. No. 66815 (April 16, 2012) http://www.sec.gov/litigation/admin/2012/33-9313.pdf*

[18] *In the Matter of Peter J. Bottini, et al., Exchange Act Rel. No. 66814 (April 16, 2012) http://www.sec.gov/litigation/admin/2012/34-66814.pdf*

[19] *In the Matter of New York Stock Exchange LLC, et al., Exchange Act Rel. No. 67857 (September 14, 2012) http://www.sec.gov/litigation/admin/2012/34-67857.pdf*

agreed to a $5 million penalty and significant undertakings to settle the SEC's charges. It marks the first-ever SEC financial penalty against an exchange.

That same month, the SEC charged a New York-based brokerage firm, Hold Brothers On-Line Investment Service, and three of its executives for allowing traders outside the U.S. to access the markets and conduct manipulative trading through accounts the firm controlled.[20] The SEC's investigation found that the firm ignored red flags indicating that overseas traders were accessing the markets through the firm's customer accounts and repeatedly manipulating publicly-traded stocks through an illegal practice known as "layering" or "spoofing." In layering, the trader places orders with no intention of having them executed but rather to trick others into buying or selling a stock at an artificial price driven by the orders that the trader later cancels. Hold Brothers' president and co-founder Steve Hold, former Chief Compliance Officer and CFO, Robert Vallone, and a third executive, William Tobias, were aware of several e-mails and other indications that manipulative trading was occurring through Hold Brothers accounts, yet they failed to properly investigate the warning signs and recklessly continued to provide overseas traders with buying power and access to the U.S. markets. The SEC also charged two Hold Brothers customers whose accounts were used for the manipulative trading. The six individuals and entities charged in the SEC's case paid a total of $4 million in disgorgement and penalties to settle the charges.

Also in September, the SEC charged three former brokers at J.P. Turner, an Atlanta-based brokerage firm, for "churning" the accounts of customers with conservative investment objectives, resulting in losses to investors while the brokers collected significant fees.[21] The SEC charged Michael Bresner, the head supervisor at J.P. Turner, as well as the firm's president, William Mello, and the firm itself for compliance failures. Churning is a fraudulent practice in which brokers disregard the customer's investment objectives and engage in excessive trading for the purpose of generating commissions and other revenue for themselves or their firms. The SEC's Enforcement Division alleges that three brokers engaged in churning while they worked at JP Turner. They collectively generated commissions, fees, and margin interest totaling approximately $845,000 while the defrauded customers suffered aggregate losses of approximately $2.7 million. JP Turner and Mello agreed to settle the SEC's charges, while an administrative proceeding will continue against the three brokers and the supervisor.

Actions Related to Mutual Funds and Investment Advisers

The Commission brought numerous actions against mutual funds, investment advisers, and investment companies in FY 2012. In October 2011, the SEC obtained an asset freeze against a Boston-area money manager and his investment advisory firm for misleading investors in a supposed quantitative hedge fund and diverting portions of investor money into his personal bank account.[22] The SEC alleged that Andrey C. Hicks and Locust Offshore Management LLC made false representations to create an aura of legitimacy when soliciting individuals to invest in a purported billion dollar hedge fund that Hicks controlled called Locust Offshore Fund Ltd. Hicks raised at least $1.7 million from several investors for the hedge fund. Among the false claims made to investors were that Hicks obtained undergraduate and graduate degrees at Harvard University, that he previously worked for Barclays Capital, and that the hedge fund held more than $1.2 billion in assets. According to the SEC's complaint, Hicks and his firm also falsely claimed that Ernst & Young served as the fund's auditor, Credit Suisse served as the fund's prime broker and custodian, and the fund was a business company incorporated under the laws of the British Virgin Islands.

The SEC charged Morgan Stanley Investment Management (MSIM) with violating the securities laws in a fee arrangement that repeatedly charged a fund and its investors for

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[20] *In the Matter of Hold Brothers On-Line Investment Services, LLC, et al., Exchange Act Rel. No. 67924 (September 25, 2012) http://www.sec.gov/litigation/admin/2012/34-67924.pdf*

[21] *In the Matter of Michael Bresner, et al., Exchange Act Rel. No. 67810 (September 10, 2012) http://www.sec.gov/litigation/admin/2012/33-9359.pdf; In the Matter of J.P. Turner, et al., Exchange Act Rel. No. 67808 (September 10, 2012) http://www.sec.gov/litigation/admin/2012/34-67808.pdf*

[22] *SEC v. Andrey C. Hicks, et al, Lit. Rel. No. 22141 (October 26, 2011) http://www.sec.gov/litigation/litreleases/2011/lr22141.htm*

advisory services they were not actually receiving from a third party.[23] The SEC's investigation found that MSIM represented to investors and the fund's board of directors that it contracted a Malaysian-based sub-adviser to provide advice, research, and assistance to MSIM for the benefit of the fund, which invests in equity securities of Malaysian companies. The sub-adviser did not provide these purported advisory services, yet the fund's board annually renewed the contract based on MSIM's representations for more than a decade at a total cost of $1.845 million to investors. The case arose out of the Asset Management Unit's initiative focusing on fee arrangements with registered funds. MSIM paid more than $3.3 million to settle the SEC's charges.

As part of Asset Management Unit's Compliance Initiative, the SEC charged three investment advisers for failing to put in place compliance procedures designed to prevent securities law violations.[24] The initiative is a proactive effort jointly conducted with SEC examiners that is designed to prevent investor harm by ensuring that viable compliance programs are in place at firms. One of the firms charged (OMNI Investment Advisers) failed to adopt and implement written compliance policies and procedures after SEC examiners had informed the firm of its deficiencies. The firm had no compliance program, its representatives were completely unsupervised, and its compliance chief performed no responsibilities and lived abroad. Another firm (Feltl & Company, Inc.) failed to adopt and implement written compliance policies and procedures that resulted in compliance failures, such as engaging in hundreds of principal transactions with its advisory clients' accounts without informing them or obtaining their consent as required by law. All of the firms settled with the SEC by, among other things, paying penalties, returning certain funds to advisory clients, and agreeing to undertakings requiring them to review and improve their compliance operations.

The SEC filed several enforcement actions charging three advisory firms and six individuals as part of the Asset Management Unit's Aberrational Performance Inquiry to combat investment adviser fraud by identifying abnormal investment performance. The misconduct involved improper use of fund assets, fraudulent valuations, and misrepresenting fund returns. Under this initiative, proprietary risk analytics were used to evaluate hedge fund returns, identifying funds whose performance was inconsistent with its investment strategy or other benchmarks. In one case, the SEC charged Michael Balboa, the portfolio manager of the Millennium Global Emerging Credit Fund, and two European-based brokers for inflating the fund's reported monthly returns and net asset value by manipulating its supposedly independent valuation process.[25] Balboa and his cohorts provided fictional prices for certain illiquid holdings to Millennium's outside valuation agent and its auditor, causing the fund to overvalue these holdings by as much as $163 million. The scheme allowed Balboa to attract new investments, deter redemptions, and generate millions of dollars in management and performance fees. In a second case, ThinkStrategy Capital and its sole managing director were charged with fraud for engaging in a pattern of deceptive conduct that sought to give investors the false impression that the fund's returns were consistently positive and minimally volatile.[26] The defendants repeatedly inflated the firm's assets, exaggerated the firm's longevity and performance history, and misrepresented the size and credentials of the firm's management team. In another action, the SEC charged Patrick Rooney and his firm Solaris Management LLC for becoming wholly invested in a financially troubled company that Rooney had been the Chairman of since 2004.[27] Rooney failed to disclose to investors his affiliation with the troubled company and he misrepresented the nature of the fund's investments in the company, many of which were interest-free loans from the fund to the company.

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[23] *In the Matter of Morgan Stanley Investment Management Inc., Advisers Act Rel. No. 3315 (November 16, 2011) http://www.sec.gov/litigation/admin/2011/ia-3315.pdf*

[24] *In the Matter of Asset Advisors, LLC, Advisers Act Rel. No. 3324 (November 28, 2011) http://www.sec.gov/litigation/admin/2011/ia-3324.pdf; In the Matter of Feltl & Company, Inc., Exchange Act Rel. No. 65838 (November 28, 2011) http://www.sec.gov/litigation/admin/2011/34-65838.pdf; In the Matter of OMNI Investment Advisors Inc., et al., Exchange Act Rel. No. 65837 (November 28, 2011) http://www.sec.gov/litigation/admin/2011/34-65837.pdf*

[25] *SEC v. Michael R. Balboa, et al., Lit. Rel. No. 22176 (December 2, 2011) http://www.sec.gov/litigation/litreleases/2011/lr22176.htm*

[26] *SEC v. Chetan Kapur, et al., Lit. Rel. No. 22151 (November 10, 2011) http://www.sec.gov/litigation/litreleases/2011/lr22151.htm*

[27] *SEC v. Patrick G. Rooney, et al., Lit. Rel. No. 22167 (November 22, 2011) http://www.sec.gov/litigation/litreleases/2011/lr22167.htm*

In a fourth action, the SEC charged LeadDog Capital and its general partners for inducing investors to invest in a hedge fund they controlled through material misrepresentations and omissions concerning the negative regulatory history of one of the general partners, the compensation arrangements of the general partners, and the general partners' substantial ownership interests in many of the companies to which they directed fund investments.[28]

At the beginning of January, the SEC charged an Illinois-based investment adviser with offering to sell fictitious securities on LinkedIn and issued two alerts in an agency-wide effort to highlight the risks investors and advisory firms face when using social media.[29] Anthony Fields offered more than $500 billion in fictitious securities through various social media websites. For example, he used LinkedIn discussions to promote fictitious "bank guarantees" and "medium-term notes." The postings resulted in interest from multiple purported potential buyers. According to the SEC's order instituting administrative proceedings against Fields, he provided false and misleading information in SEC filings concerning the firm's assets under management, clients, and operational history. Fields also failed to maintain required books and records, did not implement adequate compliance policies and procedures, and held himself out to be a broker-dealer while he was not registered with the SEC.

In March, the SEC charged two managers (Frank Mazzola and Laurence Albukerk) of private investment funds established solely to acquire pre-IPO shares of Facebook and other Silicon Valley firms with misleading investors and pocketing undisclosed fees and commissions.[30] The SEC alleges that the fund managers collectively raised more than $70 million from investors. Separately, the SEC charged SharesPost, an online service that matches buyers and sellers of pre-IPO stock, with engaging in securities transactions without registering as a broker-dealer.[31] The action against Mazzola, and his firms Felix Investments and Facie Libre Management Associates, alleges that they engaged in improper self-dealing by earning secret commissions above the 5 percent disclosed in offering materials on the funds' acquisition of Facebook stock and on re-sales of fund interests to new investors. They also sold Facie Libre fund interests despite knowing the funds lacked ownership of certain Facebook shares. Mazzolla and his firms also made false statements to investors in other funds they created to invest in various companies pre-IPO, such as Twitter and Zynga. The action against Mazzolla is continuing.

The action against Albukerk and his firm, EB Financial Group LLC, alleges that they hid from investors significant compensation earned in connection with two Facebook funds they managed. In written offering materials for the funds, Albukerk told investors he charged only a 5 percent fee for an initial investment and a 5 percent fee when the shares were distributed to fund investors upon a Facebook IPO. However, Albukerk obtained additional compensation by using an entity controlled by his wife to purchase the Facebook stock and then buying interests in that entity for the EB Funds while charging investors a mark-up. Albukerk also earned a brokerage fee on the acquisition of Facebook shares from the original stockholders. As a result of the fee and mark-up, investors in Albukerk's two Facebook funds ultimately paid significantly more than the fees disclosed in the offering materials. Albukerk and EB Financial settled with the SEC by agreeing to pay disgorgement and pre-judgment interest of $210,499 and a penalty of $100,000.

In the action against SharesPost and its CEO, the SEC alleged that they facilitated securities transactions without registering with the SEC as a broker-dealer. SharesPost engaged in a series of activities that constituted the business of effecting securities transactions and thus was required to register as a broker-dealer. SharesPost held itself out to the public as an online service to help match buyers and sellers of pre-IPO stock and allowed registered representatives of

[28] *In the Matter of LeadDog Capital Markets, LLC, et al., Exchange Act Rel. No. 65750 (November 15, 2011) http://www.sec.gov/litigation/admin/2011/33-9277.pdf*

[29] *In the Matter of Anthony Fields, CPA, et al. Exchange Act Rel. No. 66091 (January 4, 2012) http://www.sec.gov/litigation/admin/2012/33-9291.pdf*

[30] *SEC v. Frank Mazzola, et al. Lit. Rel. No. 22292 (March 14, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22292.htm; In the Matter of Laurence Albukerk, et al., Securities Act Rel. No. 9302 (March 14, 2012) http://www.sec.gov/litigation/admin/2012/33-9302.pdf*

[31] *In the Matter of Sharespost, Inc., et al., Exchange Act Rel. No. 66594 (March 14, 2012) http://www.sec.gov/litigation/admin/2012/34-66594.pdf*

other broker-dealers to hold themselves out as SharesPost employees and earn commissions on transactions they facilitated through the SharesPost platform. SharesPost and the CEO settled with the SEC by paying civil penalties totaling $100,000. SharesPost is now registered as a broker-dealer.

At the beginning of May, the SEC charged UBS Financial Services Inc. of Puerto Rico and two executives with making misleading statements to investors, concealing a liquidity crisis, and masking its control of the secondary market for 23 proprietary closed-end mutual funds.[32] According to the SEC's settled order, UBS Puerto Rico knew about a significant "supply and demand imbalance" and discussed the "weak secondary market" internally. However, UBS Puerto Rico misled investors and failed to disclose that it controlled the secondary market, where investors sought to sell their shares in the funds. UBS Puerto Rico significantly increased its inventory holdings in the closed-end funds to prop up market prices, bolster liquidity, and promote the appearance of a stable market. However, UBS Puerto Rico later withdrew its market price and liquidity support in order to sell 75 percent of its closed-end fund inventory to unsuspecting investors. UBS Puerto Rico settled the SEC's charges by paying $26.6 million that will be placed into a fund for harmed investors.

The following month, the SEC filed fraud charges against New York-based hedge fund adviser Philip A. Falcone and his advisory firm, Harbinger Capital Partners LLC, for illicit conduct that included misappropriation of client assets, market manipulation, and betraying clients.[33] The SEC also charged Peter A. Jenson, Harbinger's former COO, for aiding and abetting the misappropriation scheme. Additionally, the SEC reached a settlement with Harbinger for unlawful trading. In a separate, settled action, the SEC charged Harbert Management Corporation, whose affiliates served as the managing members of two Harbinger-related entities, as a controlling person in the market manipulation. In particular, the SEC alleges that Falcone fraudulently obtained $113.2 million from a hedge fund that he advised and misappropriated the proceeds to pay his personal taxes; secretly favored certain customers at the expense of others by granting favorable redemption and liquidity rights to certain strategically-important investors in exchange for those investors' consent to restrict redemption rights of other fund investors; and that Harbinger engaged in illegal trades in connection with the purchase of common stock in three public offerings after having sold the same securities short during a restricted period.

Actions Related to Insider Trading

Insider trading remained a high priority in FY 2012, with the Commission filing 58 insider trading actions. Many of these cases involved financial professionals, hedge funds managers, corporate insiders, and others who unlawfully traded on material, nonpublic information, undermining the level playing field that is fundamental to the integrity and fairness of the securities markets. In FY 2012, the SEC charged former McKinsey & Co. global head Rajat Gupta with insider trading for illegally tipping convicted hedge fund manager Raj Rajaratnam while serving on the boards of Goldman Sachs and Procter & Gamble.[34] The complaint also included new insider trading charges against Rajaratnam. According to the SEC's complaint, Gupta illegally tipped Rajaratnam with inside information about the quarterly earnings of both Goldman Sachs and Procter & Gamble as well as an impending $5 billion investment in Goldman by Berkshire Hathaway at the height of the financial crisis. Rajaratnam caused Galleon funds to trade on the information conveyed by Gupta, generating illicit profits or loss avoidance of more than $23 million. The SEC's complaint seeks injunctive relief, joint and several disgorgement, civil penalties, and an officer and director bar and industry bars against Gupta. Gupta was convicted by a jury in a related Federal criminal prosecution and sentenced to two years in prison for this conduct.

In January, the SEC charged two, multi-billion dollar hedge fund advisory firms as well as seven fund managers and analysts for a $78 million insider trading scheme based on material, nonpublic information about Dell's quarterly earnings and other similar inside information about Nvidia

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[32] *In the Matter of UBS Financial Services Inc. of Puerto Rico, Exchange Act Rel. No. 66893 (May 1, 2012) http://www.sec.gov/litigation/admin/2012/33-9318.pdf*

[33] *SEC v. Harbinger Capital Partners LLC, et al., Lit. Rel. No. 22403 (June 28, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22403.htm*

[34] *SEC v. Gupta, et al., Lit. Rel. No. 22140 (October 26, 2011) http://www.sec.gov/litigation/litreleases/2011/lr22140.htm*

Corporation.[35] The scheme involved a network of closely associated hedge fund traders at Diamondback Capital Management and Level Global Investors LP, who illegally obtained inside information about Dell and Nvidia and, subsequently, traded on this information and passed it along to others, who, in turn, traded on it. The charges stem from the SEC's ongoing investigation into trading by hedge funds. Diamondback paid more than $9 million to settle the SEC's charges.

The next month, the SEC charged Douglas Whitman, a hedge fund manager, and his California-based firm, Whitman Capital, for their involvement in the insider trading ring connected to Raj Rajaratnam and Galleon Management.[36] According to the SEC's complaint, Whitman and his firm traded on material, nonpublic information obtained from Rajaratnam's associate, Roomy Khan, who was Whitman's friend and neighbor. The tips provided to Whitman involved confidential details about Polycom Inc. and Google. These inside tips allowed Whitman to obtain nearly $1 million in ill-gotten gains.

The same month, the SEC charged John Kinnucan and his Portland, Oregon-based expert consulting firm, Broadband Research Corporation, with insider trading.[37] Kinnucan and Broadband claimed to be in the business of providing clients with legitimate research about technology companies, but instead they typically tipped clients with material, nonpublic information that Kinnucan obtained from prohibited sources inside the companies. Clients then traded on the information. Portfolio managers and analysts at prominent hedge funds and investment advisers paid Kinnucan and Broadband significant consulting fees for the information they provided. Kinnucan in turn compensated his sources with cash, meals, ski trips, and other vacations. He even befriended some sources to gain access to confidential information. This matter arose out of the SEC's expert networks investigation, which has uncovered alleged insider trading in the securities of more than a dozen issuers, resulting in illicit gains of nearly $120 million.

In May, the SEC charged a former executive at Yahoo!, Inc. and a former mutual fund manager at a subsidiary of Ameriprise Financial, Inc. with insider trading on confidential information about a search engine partnership between Yahoo and Microsoft Corporation.[38] The SEC alleged that Robert W. Kwok, who was Yahoo's senior director of business management, breached his duty to the company when he told Reema D. Shah in July 2009 that a deal between Yahoo and Microsoft would be announced soon. Shah had reached out to Kwok amid market rumors of an impending partnership between the two companies, and Kwok told her the information was kept quiet at Yahoo and only a few people knew of the coming announcement. Based on Kwok's illegal tip, Shah prompted the mutual funds she managed to buy more than 700,000 shares of Yahoo stock that were later sold for profits of approximately $389,000. The SEC also alleged that a year earlier, the roles were reversed. Shah tipped Kwok with material, nonpublic information about an impending acquisition announcement between two other companies. Kwok traded in a personal account based on the confidential information. Kwok and Shah settled the SEC's charges by paying civil penalties, with disgorgement to be determined by the court. Under the settlements, Shah was permanently barred from the securities industry and Kwok was permanently barred from serving as an officer or director of a public company.

In July, the SEC charged five physicians with insider trading in the securities of an East Lansing, Michigan-based holding company for a medical professional liability insurer.[39] The SEC alleged that Apparao Mukkamala learned confidential information from board meetings and other communications about the anticipated acquisition of American Physicians Capital Inc. (ACAP) by another insurance company. Mukkamala shared the nonpublic information with three physicians and friends as well as his brother-in-law. The five physicians each purchased ACAP stock based on confidential information about the impending sale in the months leading up to a public announcement.

[35] *SEC v. Adondakis, et al., Lit. Rel. No. 22230 (January 19, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22230.htm*

[36] *SEC v. Whitman, et al., Lit. Rel. No. 22257 (February 10, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22257.htm*

[37] *SEC v. Kinnucan, et al., Lit. Rel. No. 22261 (February 17, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22261.htm*

[38] *SEC v. Shah, et al., Lit. Rel. No. 22372 (May 22, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22372.htm*

[39] *SEC v. Apparao Mukkamala, et al., Lit. Rel. No. 22413 (July 10, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22413.htm*

Collectively, they made more than $623,000 in illegal profits on their ACAP stock purchases. The physicians paid a combined total of more than $1.9 million to settle the SEC's charges.

Also in July, the SEC took emergency action to freeze the assets of traders using accounts in Hong Kong and Singapore to hold more than $13 million in illegal profits by trading in advance of a public announcement that China-based CNOOC Ltd. was acquiring Canada-based Nexen Inc.[40] The SEC's complaint alleged that Hong Kong-based firm Well Advantage Ltd. and other unknown traders stockpiled shares of Nexen stock based on confidential information about the deal in the days leading up to the announcement. The SEC took the emergency action within days of the public announcement of the deal and less than 24 hours after Well Advantage placed an order to liquidate its entire position in Nexen. Well Advantage purchased more than 830,000 shares of Nexen on July 19 and had an unrealized trading profit of more than $7 million based on Nexen's closing price on the day of the announcement. The other unknown traders used accounts located in Singapore to purchase more than 676,000 Nexen shares in the days preceding the announcement. They immediately sold nearly all of the stock once the announcement was made for illicit profits of approximately $6 million. In October, Well Advantage agreed to settle the SEC's charges by paying more than $14 million, which is double the amount of its alleged illicit profits.[41]

In another action filed in July, the SEC charged the chairman and CEO of a California-based computer storage device company with insider trading in a secondary offering of his stock shares with knowledge of confidential information that a major customer's demand for one of its most profitable products was turning out to be less than expected.[42] The SEC alleged that Manouchehr Moshayedi sought to take advantage of a dramatically upward trend in the stock price of STEC, Inc. by deciding to sell a significant portion of his stock holdings as well as shares owned by his brother, a company co-founder. The secondary offering was set to coincide with the release of the company's financial results for the second quarter of 2009 and its revenue guidance for the third quarter. However, in the days leading up to the secondary offering, Moshayedi learned critical nonpublic information that was likely to have a detrimental impact on the stock price. Moshayedi did not call off the offering and abstain from selling his shares once he possessed the negative information. Instead, he engaged in a fraudulent scheme to hide the truth through a secret side deal, and proceeded with the sale of 9 million shares from which he and his brother reaped gross proceeds of approximately $134 million each. Litigation in this case is continuing.

The SEC brought a second round of charges in an insider trading case involving former professional baseball players and the former top executive at Advanced Medical Optics, Inc., a California-based medical eye products company that was the subject of the illegal trading. In 2011, the SEC charged former professional baseball player Doug DeCinces and three others with insider trading on confidential information ahead of an acquisition of Advanced Medical Optics. In August 2012, the SEC charged James V. Mazzo, who was the Chairman and CEO of Advanced Medical Optics, and the alleged source of DeCinces's illegal tips about the impending transaction.[43] DeCinces and Mazzo are close friends and neighbors. The SEC also charged two others who traded on inside information that DeCinces tipped to them – DeCinces' former Baltimore Orioles teammate Eddie Murray and another friend, David L. Parker, who is a businessman living in Utah. The SEC alleged that Murray made approximately $235,314 in illegal profits after Illinois-based Abbott Laboratories, Inc. publicly announced its plan to purchase Advanced Medical Optics through a tender offer. Murray agreed to settle the SEC's charges by paying $358,151. Litigation in the SEC's action against Parker and Mazzo continues.

Actions Involving Market Manipulation

In April, the SEC charged AutoChina International Limited and 11 investors, including a senior executive and director at

[40] *SEC v. Well Advantage Ltd., et al., Lit. Rel. No. 22428 (July 30, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22428.htm*

[41] *SEC v. Well Advantage Ltd., et al., Lit. Rel. No. 22515 (October 19, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22515.htm*

[42] *SEC v. Manouchehr Moshayedi, et al., Lit. Rel. No. 22419 (July 20, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22419.htm*

[43] *SEC v. James V. Mazzo, et al., Lit. Rel. No. 22451 (August 17, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22451.htm*

the China-based firm, with conducting a market manipulation scheme to create the false appearance of a liquid and active market for AutoChina's stock.[44] According to the SEC's complaint, an AutoChina senior executive and director, a former AutoChina manager, and others fraudulently traded AutoChina's stock to boost its daily trading volume. Starting in October 2010, the defendants and others deposited more than $60 million into U.S.-based brokerage accounts and engaged in hundreds of fraudulent trades over the next three months through these accounts and accounts with a Hong Kong-based broker-dealer. The fraudulent trades included matched orders, where one account sold shares to another account at the same time and for the same price, and wash trades, which resulted in no change of beneficial ownership of the shares. AutoChina and the other defendants engaged in the scheme after lenders offered AutoChina unfavorable terms for a stock-backed loan due to low trading volume in its stock.

In May, the SEC suspended trading in the securities of 379 dormant companies before they could be hijacked by fraudsters and used to harm investors through reverse mergers or pump-and-dump schemes.[45] The trading suspension marks the most companies ever suspended in a single day by the Commission as it ramps up its crackdown against fraud involving microcap shell companies that are dormant and delinquent in their public disclosures. Microcap companies typically have limited assets and low-priced stock that trades in low volumes. An initiative tabbed Operation Shell-Expel by the SEC's Microcap Fraud Working Group utilized various agency resources, including the enhanced intelligence technology of the Enforcement Division's Office of Market Intelligence, to scrutinize microcap stocks in the markets nationwide and identify clearly dormant shell companies in 32 states and six foreign countries that were ripe for potential fraud.

Actions Involving Financial Fraud and Issuer Disclosure

Accounting and financial fraud, issuer disclosure, and reporting violations at public companies remained a priority for the Commission in FY 2012. In January, the SEC charged Texas-based financial services firm Life Partners Holdings, Inc. and three of its senior executives for their involvement in a fraudulent disclosure and accounting scheme involving life settlements.[46] The SEC alleges that Life Partners chairman and CEO, the president and general counsel, and the CFO misled shareholders by failing to disclose a significant risk to Life Partners' business: the company was systematically and materially underestimating the life expectancy estimates it used to price transactions. Life expectancy estimates are a critical factor impacting the company's revenues and profit margins as well as the company's ability to generate profits for its shareholders. The SEC alleges that Life Partners and the three executives were involved in disclosure violations and improper accounting that Life Partners used to overvalue assets held on the company's books and create the appearance of a steady stream of earnings from brokering life settlement transactions.

In two cases arising out of the SEC's Cross Border Initiative, the SEC brought actions against China-based companies and their executives for making misleading statements to investors in U.S. stock markets. In February, the SEC charged two senior executives of Puda Coal, Inc. with defrauding investors into believing they were investing in a Chinese coal business when in fact they were investing in an empty shell company.[47] The SEC alleges that the company's chairman and its former CEO schemed to steal and sell Puda Coal's sole revenue-producing asset, a coal mining company named Shanxi Puda Coal Group. The company's chairman secretly transferred Puda Coal's controlling interest in Shanxi Coal to himself and then sold a substantial portion to a fund controlled by what is reported to be China's largest state-owned financial firm. The scheme enabled him rather than Puda Coal's public shareholders to profit from a lucrative

[44] *SEC v. Autochina International Ltd., et al., Lit. Rel. No. 22326 (April 11, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22326.htm*

[45] *In the Matter of 1-800-ATTORNEY, Inc., et al., Exchange Act Rel. No. 66980 (May 14, 2012) http://www.sec.gov/litigation/suspensions/2012/34-66980.pdf*

[46] *SEC v. Life Partners Holdings, Inc., et al., Lit. Rel. No. 22219 (January 4, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22219.htm*

[47] *SEC v. Ming Zhao, et al., Lit. Rel. No. 22264 (February 22, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22264.htm*

business opportunity. The SEC alleges that the executives failed to disclose these transactions in Puda Coal's periodic reports to the SEC, and continued to raise funds from U.S. investors by conducting two public offerings to purportedly raise capital to enable Shanxi Coal to acquire coal mines. Unbeknownst to investors, Puda Coal no longer had an ownership stake in that company after the chairman's secret maneuvers. In reality, the scheme left Puda Coal as a shell company with no ongoing business operations.

The SEC charged China-based China Sky One Medical Inc. (CSKI) and its CEO with fraud for recording fake sales of a weight loss product to inflate revenues in the company's financial statements by millions of dollars.[48] The SEC alleges that CSKI falsely stated in its 2007 annual and quarterly reports that it had entered into a strategic distribution agreement with a Malaysian company that would become the "exclusive" distributor of CSKI's "slim patch" in Malaysia, generating $1 million in monthly sales. However, the company never actually entered into any such agreement. CSKI instead created approximately $19.8 million in phony export sales to Malaysia that were recorded as revenue in its financial results for 2007 and 2008. The company's CEO certified the overstated financial results, which appear in CSKI's financial statements through 2010 and continue to impact the company's retained earnings on its balance sheet.

The SEC brought an enforcement action against Shanghai-based Deloitte Touche Tohmatsu CPA Ltd. for its refusal to provide the agency with audit work papers related to a China-based company under investigation for potential accounting fraud against U.S. investors.[49] According to the SEC's order instituting administrative proceedings against D&T Shanghai, the agency has been making extensive efforts for more than two years to obtain documents related to the firm's audit work for the Chinese company, which issues U.S. securities registered with the SEC. The Division of Enforcement alleges that D&T Shanghai violated Section 106 of the Sarbanes-Oxley Act, which requires foreign public accounting firms to provide audit work papers concerning U.S. issuers to the SEC upon request. D&T Shanghai did not provide the documents, citing Chinese law as the reason for its refusal. This is the first time the Commission has brought an enforcement action against a foreign audit firm for failing to comply with a Section 106 request. The SEC's action in this matter is continuing.

Actions Involving Foreign Corrupt Practices

The SEC charged seven former Seimens executives with FCPA violations for their actions in the decade-long bribery scheme to retain a $1 billion government contract to produce national identity cards for Argentine citizens.[50] The executives falsified documents including invoices and sham consulting contracts, and participated in meetings in the United States to negotiate the terms of bribe payments, which exceeded $100 million over the course of the scheme. Each of the executives charged had a role in authorizing, negotiating, facilitating, or concealing bribe payments. Six of the 7 executives are litigating.

In December, the SEC charged Magyar Telekom Plc., Hungary's largest telecommunications provider, and three of its former top executives with bribing government and political party officials in Macedonia and Montenegro to win business and shut out competition in the telecommunications industry.[51] The SEC's complaint alleged that three senior executives at Magyar Telekom orchestrated, approved, and executed a plan to bribe Macedonian officials in 2005 and 2006 to prevent the introduction of a new competitor and gain other regulatory benefits. Magyar Telekom's subsidiaries in Macedonia made illegal payments of approximately $6 million under the guise of bogus consulting and marketing contracts. The same executives orchestrated a second scheme in 2005 in Montenegro related to Magyar Telekom's acquisition of the state-owned telecommunications company there. Magyar Telekom paid approximately $9 million through four sham contracts to funnel money to government officials in Montenegro. Magyar Telekom's parent company Deutsche

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[48] *SEC v. China Sky One Medical, Inc., et al., Lit. Rel. No. 22470 (September 4, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22470.htm*

[49] *In the Matter of Deloitte Touche Tohmatsu Certified Public Accountants Ltd., Exchange Act Rel. No. 66948 (May 9, 2012) http://www.sec.gov/litigation/admin/2012/34-66948.pdf*

[50] *SEC v. Uriel Sharef, et al., Lit. Rel. No. 22190 (December 13, 2011) http://www.sec.gov/litigation/litreleases/2011/lr22190.htm*

[51] *SEC v. Magyar Telekom Plc., et al.; SEC v. Straub, et al., Lit. Rel. No. 22213 (December 29, 2011) http://www.sec.gov/litigation/litreleases/2011/lr22213.htm*

Telekom AG also was charged with books and records and internal controls violations of the FCPA. Magyar Telekom agreed to settle the SEC's charges by paying more than $31.2 million in disgorgement and pre-judgment interest. Magyar Telekom also agreed to pay more than $59 million in criminal penalties to the U.S. Department of Justice.

In March, the SEC charged Indiana-based medical device company Biomet, Inc. with violating the FCPA when its subsidiaries and agents bribed public doctors in Argentina, Brazil, and China for nearly a decade to win business.[52] Biomet, which primarily sells products used by orthopedic surgeons, paid more than $22 million to settle the SEC's charges as well as parallel criminal charges announced by the U.S. Department of Justice. The charges arose from the SEC and DOJ's proactive global investigation into medical device companies bribing publicly-employed physicians. The SEC alleged that Biomet and its four subsidiaries paid bribes from 2000 to 2008, and employees and managers at all levels of the parent company and the subsidiaries were involved along with the distributors who sold Biomet's products. Biomet's compliance and internal audit functions failed to stop the payments to doctors even after learning about the illegal practices. Employees of Biomet Argentina SA paid kickbacks as high as 15 to 20 percent of each sale to publicly-employed doctors in Argentina. Phony invoices were used to justify the payments, and the bribes were falsely recorded as "consulting fees" or "commissions" in Biomet's books and records. Executives and internal auditors at Biomet's Indiana headquarters were aware of the payments as early as 2000, but failed to stop them. Biomet's U.S. subsidiary, Biomet International, used a distributor to bribe publicly-employed doctors in Brazil by paying them as much as 10 to 20 percent of the value of their medical device purchases. Also, two additional subsidiaries – Biomet China and Scandimed AB – sold medical devices through a distributor in China who provided publicly-employed doctors with money and travel in exchange for their purchases of Biomet products.

In another matter stemming from the SEC's and DOJ's global investigation of bribery of publicly-employed physicians by medical device companies, the SEC charged London-based medical device company Smith & Nephew PLC with violating the FCPA when its U.S. and German subsidiaries bribed public doctors in Greece for more than a decade to win business.[53] The SEC's complaint against Smith & Nephew PLC alleged that its subsidiaries used a distributor to create a slush fund to make illicit payments to public doctors employed by government hospitals or agencies in Greece. On paper, it appeared as though Smith & Nephew's subsidiaries were paying for marketing services, but no services were actually performed. The scheme created off-shore funds that were not subject to Greek taxes to pay bribes to public doctors to purchase Smith & Nephew products. Smith & Nephew PLC and its U.S. subsidiary Smith & Nephew Inc. paid more than $22 million to settle the SEC's and DoJ's actions.

In April, the SEC charged Garth R. Peterson, a former executive at Morgan Stanley's real estate investment and fund advisory business, with violating the FCPA as well as securities laws for investment advisers by secretly acquiring millions of dollars of real estate investments for himself and an influential Chinese official who in turn steered business to Morgan Stanley's funds.[54] The SEC's complaint alleged that Peterson had a personal friendship and secret business relationship with the former chairman of a Chinese state-owned entity with influence over the success of Morgan Stanley's real estate business in Shanghai. Peterson secretly arranged to have at least $1.8 million paid to himself and the Chinese official that he disguised as finder's fees that Morgan Stanley's funds owed to third parties. Peterson also secretly arranged for him, the Chinese official, and an attorney to acquire a valuable Shanghai real estate interest from a Morgan Stanley fund. Peterson was acquiring an interest from the fund but negotiated both sides of the transaction. In exchange for offers and payments from Peterson, the Chinese official helped Peterson and Morgan Stanley obtain business while personally benefitting from some of these same investments. Peterson's deception, self-dealing, and misappropriation breached the fiduciary duties he owed to Morgan Stanley's funds as their representative. Peterson settled the SEC's charges by paying more than $250,000 in disgorgement and relinquishing his interest in the valuable Shanghai real estate (currently valued at approximately $3.4 million) that he

[52] *SEC v. Biomet, Inc., Lit. Rel. No. 22306 (March 26, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22306.htm*

[53] *SEC v. Smith & Nephew plc, Lit. Rel. No. 22252 (February 6, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22252.htm*

[54] *SEC v. Peterson, Lit. Rel. No. 22346 (April 25, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22346.htm*

secretly acquired through his misconduct. He also agreed to be permanently barred from the securities industry.

In August, the SEC charged Pfizer, Inc. with violating the FCPA when its subsidiaries bribed doctors and other health care professionals employed by foreign governments in order to win business.[55] The SEC alleged that employees and agents of Pfizer's subsidiaries in Bulgaria, China, Croatia, Czech Republic, Italy, Kazakhstan, Russia, and Serbia made improper payments to foreign officials to obtain regulatory and formulary approvals, sales, and increased prescriptions for the company's pharmaceutical products. They tried to conceal the bribery by improperly recording the transactions in accounting records as legitimate expenses for promotional activities, marketing, training, travel and entertainment, clinical trials, freight, conferences, and advertising. The SEC also separately charged another pharmaceutical company that Pfizer acquired a few years ago – Wyeth LLC – with FCPA violations. Pfizer and Wyeth agreed to separate settlements in which they paid more than $45 million combined to settle their respective charges. In a parallel action, Pfizer H.C.P. Corporation paid a $15 million penalty to resolve the DoJ's FCPA investigation.

Actions Involving Offering Frauds/Ponzi Schemes

In October 2011, the SEC filed an emergency action to halt a Ponzi scheme that promised investors rich returns on water-filtering natural stone pavers, but bilked them of approximately $26 million over a four-year period.[56] The SEC alleged that convicted felon Eric Aronson and others defrauded investors in PermaPave Companies, a group of firms based on Long Island, N.Y., and controlled by Aronson. About 140 individuals, many working in the construction or landscaping business, invested in the scheme between 2006 and 2010. Investors were told that PermaPave Companies had a tremendous backlog of orders for pavers imported from Australia, which could be sold in the U.S. at a substantial mark-up, yielding monthly returns to investors of 7.8 percent to 33 percent. In reality, there was little demand for the product, and the cost of the pavers far exceeded the revenue from sales. Lacking the profits promised to investors, Aronson and two other PermaPave Companies executives, Vincent Buonauro Jr., and Robert Kondratick, used new investments to make payments to earlier investors and then siphoned off much of the rest for themselves, buying luxury cars, gambling trips to Las Vegas, and jewelry. Aronson allegedly used investors' money to make court-ordered restitution payments to victims of a previous scheme to which he pleaded guilty to in 2000. When investors began demanding money owed to them, Aronson accused them of committing a felony by lending the PermaPave Companies money at the interest rates he promised them, which he suddenly claimed were usurious. Aronson and his attorney, Fredric Aaron, then allegedly made false statements to persuade investors to convert their securities into ones that deferred payments owed them for several years. Finally, the defendants used some of the money raised through the Ponzi scheme to purchase a publicly traded company, Interlink-US-Network, Ltd. Several months later, Interlink issued a Form 8-K, signed by Kondratick, which falsely stated that LED Capital Corp. had agreed to invest $6 million in Interlink. LED Capital Corp. purportedly did not have $6 million and had no dealings, let alone any agreements, with Interlink.

The SEC filed an emergency action to halt an ongoing Ponzi scheme that targeted members of the Persian-Jewish community in Los Angeles.[57] The SEC alleged that for the past two years, Shervin Neman raised more than $7.5 million from investors by claiming to be a hedge fund manager. Neman told investors that his purported hedge fund – Neman Financial L.P. – invested in foreclosed residential properties that would be quickly flipped for profit as well as in Facebook shares obtained in private transactions and other highly anticipated IPOs, including Groupon, LinkedIn, and Angie's List. Although Neman promised investors exorbitant returns resulting from his investing acumen and access to pre-IPO shares of well-known companies, what they actually received was simply other investors' money in hallmark Ponzi scheme fashion. Neman raised funds from at least 11 investors in the fraudulent securities offering. Most of the investors are members of the Los Angeles Persian-Jewish community.

[55] *SEC v. Pfizer Inc. and SEC v. Wyeth LLC, Lit. Rel. No. 22438 (August 8, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22438.htm*

[56] *SEC v. Eric Aronson, et al., Lit. Rel. No. 22117 (October 6, 2011) http://www.sec.gov/litigation/litreleases/2011/lr22117.htm*

[57] *SEC v. Shervin Neman, et al., Lit. Rel. No. 22331 (April 13, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22331.htm*

More than 99 percent of the money Neman raised was used either to pay existing investors or fund his lavish lifestyle.

The SEC charged 14 sales agents who misled investors and illegally sold securities for a Long Island-based investment firm at the center of a $415 million Ponzi scheme.[58] The SEC alleged that the sales agents — including four sets of siblings — falsely promised investor returns as high as 12 to 14 percent in several weeks when they sold investments offered by Agape World, Inc. They also misled investors to believe that only 1 percent of their principal was at risk. The Agape securities they peddled were actually non-existent, and investors were merely lured into a Ponzi scheme where earlier investors were paid with new investor funds. The sales agents turned a blind eye to red flags of fraud and sold the investments without hesitation, receiving more than $52 million in commissions and payments out of investor funds. None of these sales agents were registered with the SEC to sell securities, nor were they associated with a registered broker or dealer. Agape also was not registered with the SEC. Further, more than 5,000 investors nationwide were impacted by the scheme that lasted from 2005 to January 2009, when Agape's president and organizer of the scheme, Nicholas J. Cosmo, was arrested. He was later sentenced to 300 months in prison and ordered to pay more than $179 million in restitution. The sales agents allegedly misrepresented to investors that their money would be used to make high-interest bridge loans to commercial borrowers or businesses that accepted credit cards. Little, if any, investor money actually went toward this purpose. Investor funds were instead used for Ponzi scheme payments and the agents' sales commissions, and Cosmo lost $80 million while trading futures in personal accounts. Meanwhile, the sales agents assuredly offered and sold Agape securities to investors despite numerous indicia of fraud including Cosmo's prior conviction for fraud, the too-good-to-be-true returns, and the incredible safety of principal promised to investors. The sales agents also ignored Agape's relatively small and unknown status as a private issuer of securities, Agape's series of extensions and defaults, and other dire warnings about Agape's financial condition. None of the Agape securities offerings were registered with the SEC.

In June, the SEC took emergency action to halt a real estate-based Ponzi scheme that defrauded more than 600 investors nationwide of $100 million.[59] The SEC's action charged Wayne L. Palmer and his firm, National Note of Utah, LC, with fraud in a scheme in which he raised money from investors by promising to use the proceeds to buy mortgage notes and other real estate assets. Palmer told investors that their money would be completely secure and that National Note had a perfect record, having never missed paying principal or interest on its promissory notes. Glossy marketing materials that Palmer provided to some investors showed that National Note returns did not fluctuate and stated that investors were guaranteed payment even if property owners missed payment on mortgage loans that National Note held. Contrary to Palmer's claims, National Note used most of the money it took in from new investors to pay earlier investors, making it a classic Ponzi scheme. According to the SEC's complaint, National Note would not have been able survive but for the influx of new investor funds, and that its payments to investors all but stopped in October 2011.

In August, the SEC filed fraud charges against a former college football coach who teamed with an Ohio man to conduct an $80 million Ponzi scheme that included other college coaches and former players among its victims.[60] The SEC alleged that Jim Donnan, a College Football Hall of Fame inductee who guided teams at Marshall University and the University of Georgia and later became a television commentator, conducted the fraud with his business partner Gregory Crabtree through a West Virginia-based company called GLC Limited. Donnan and Crabtree told investors that GLC was in the wholesale liquidation business and earned substantial profits by buying leftover merchandise from major retailers and reselling those discontinued, damaged, or returned products to discount retailers. They promised investors exorbitant rates of return ranging from 50 to 380 percent. However, only about $12 million of the $80 million raised from nearly 100 investors was actually used to purchase leftover merchandise; the remaining funds were used to pay fake returns to earlier investors or stolen for other uses by Donnan and Crabtree. The scheme allegedly began in August 2007 and collapsed in October 2010. Donnan recruited the

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[58] *SEC v. Bryan Arias, et al., Lit. Rel. No. 22391 (June 12, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22391.htm*

[59] *SEC v. National Note of Utah, LC, et al., (June 25, 2012) Rel. No. 2012-119 http://www.sec.gov/news/press/2012/2012-119.htm*

[60] *SEC v. James Donnan, III, et al., Lit. Rel. No. 22453 (August 17, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22453.htm*

majority of investors by approaching contacts he made as a sports commentator and as a coach. Donnan also touted GLC's success and profitability and told investors that the company could enter into even more merchandise deals with more capital. Donnan and Crabtree offered and sold investments that were short-term (2 to 12 months) and purportedly high-yield, with returns paid to investors in monthly or quarterly installments or in a one-time payment. Donnan told investors their money was being used to purchase specific items of merchandise that was often presold, so there was little to no risk to investing in any deal. However, much of the merchandise that GLC actually purchased was merely left unsold and abandoned in warehouses in West Virginia and Ohio. Donnan typically assured investors that he was investing along with them in any merchandise deal that he offered. He touted that he and other prominent college football coaches had successfully and profitably invested in GLC. But by the time the scheme collapsed, Donnan siphoned more than $7 million away from GLC, and Crabtree misappropriated approximately $1 million in investor funds.

That same month, the SEC filed fraud charges and an emergency asset freeze to halt a $600 million Ponzi scheme on the verge of collapse.[61] The SEC alleged that online marketer Paul Burks of Lexington, N.C. and his company, Rex Venture Group, had raised money from more than one million Internet customers nationwide and overseas through the website ZeekRewards.com, which they began in January 2011. Customers were allegedly offered several ways to earn money through the ZeekRewards program, two of which involved purchasing securities in the form of investment contracts. These securities offerings were not registered with the SEC as required under the Federal securities laws. Investors were collectively promised up to 50 percent of the company's daily net profits through a profit sharing system in which they accumulate rewards points that they can use for cash payouts. However, the website fraudulently conveyed the false impression that the company was extremely profitable when, in fact, the payouts to investors bore no relation to the company's net profits. Most of ZeekRewards' total revenues and the "net profits" paid to investors have been comprised of funds received from new investors in classic Ponzi scheme fashion. The scheme was teetering on collapse with investor funds at risk of dissipation at the time of the SEC's emergency enforcement action. In the prior month, ZeekRewards brought in approximately $162 million while total investor cash payouts were approximately $160 million. If customers continued to increasingly elect to receive cash payouts rather than reinvesting their money to reach higher levels of rewards points, ZeekRewards' cash outflows would eventually exceed its total revenue.

Actions Involving Municipal Securities

In December, the SEC filed the final two actions in a series of cases in a wide-ranging complex bid-rigging scheme involving several financial firms related to the reinvestment of proceeds from the sale of municipal securities. In these two actions, the SEC charged Wachovia Bank N.A. with fraudulently rigging the bids of at least 58 municipal bond reinvestment transactions in 25 states and Puerto Rico and General Electric Funding Capital Market Services with fraudulently rigging the bids of at least 328 municipal bond transactions in 44 states and Puerto Rico.[62] The bid-rigging involved the temporary investment of proceeds of tax-exempt municipal securities. The fraudulent practices both affected the prices of the reinvestment products and jeopardized the tax-exempt status of the underlying municipal securities. Under the scheme, Wachovia and GE Funding won some bids through a practice known as "last looks" in which they obtained information from the bidding agents about competing bids. Wachovia also won bids through "set-ups" in which the bidding agent deliberately obtained non-winning bids from other providers in order to rig the field in Wachovia's favor. Wachovia and GE Funding also facilitated some bids rigged for others to win by deliberately submitting non-winning bids. Wachovia paid $46 million and GE Funding paid $25 million in penalties, disgorgement, and interest to settle the SEC's charges. These firms also paid more than $167 million to settle actions with other Federal and state authorities for this misconduct. In total, all of the firms involved in this misconduct (including those charged by the SEC prior to FY 2012)

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[61] *SEC v. Rex Group LLC, et al., Lit. Rel. No. 22456 (August 22, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22456.htm*

[62] *SEC v. Wachovia Bank, N.A., n/k/a Wells Fargo Bank, N.A., successor by merger, Lit. Rel. No. 22183 (December 8, 2011) http://www.sec.gov/litigation/litreleases/2011/lr22183.htm; SEC v. GE Funding Capital Market Services, Inc., Lit. Rel. No. 22210 (December 23, 2011) http://www.sec.gov/litigation/litreleases/2011/lr22210.htm*

have collectively paid $205 million to settle the Commission's actions. These funds have been distributed to hundreds of harmed municipal entities or borrowers, located in 47 states, the District of Columbia, Guam, and Puerto Rico. In addition, these firms have paid an additional $540 million to settle parallel proceedings by other Federal and state authorities for their misconduct. The SEC brought these actions in coordination with the Antitrust Division of the Department of Justice, the Internal Revenue Service, the Office of the Comptroller of the Currency, and 26 State Attorneys General.

In another significant matter, the SEC charged former Detroit mayor Kwame M. Kilpatrick, former city treasurer Jeffrey W. Beasley, and MayfieldGentry Realty Advisors LLC, the investment adviser to Detroit's public pension funds, for a pay-to-play scheme involving the secret exchange of lavish gifts in exchange for influence over the funds' investment process.[63] The SEC alleged that Kilpatrick and Beasley, who were trustees to the pension funds, solicited and received $125,000 worth of private jet travel and other perks paid for by MayfieldGentry, whose CEO, Chauncey Mayfield, was recommending to the trustees that the pension funds invest approximately $117 million in a real estate investment trust controlled by the firm. Despite their fiduciary duties, none of the Defendants informed the board of trustees about these trips and the conflicts of interest they presented. The funds ultimately voted to approve the REIT investment, and MayfieldGentry received millions of dollars in management fees. Litigation against Kilpatrick, Beasley, and Mayfield Gentry is ongoing.

The SEC charged Wells Fargo for improperly selling asset-backed commercial paper (ABCP) structured with high-risk mortgage-backed securities and CDOs to municipalities, non-profit institutions, and other customers, almost exclusively upon the basis of their credit ratings.[64] According to the SEC's order, the improper sales occurred from January 2007 to August 2007. Registered representatives in Wells Fargo's Institutional Brokerage and Sales Division made recommendations to institutional customers to purchase ABCP issued by limited purpose companies called structured investment vehicles (SIVs) and SIV-Lites backed largely by mortgage-backed securities and CDOs. Wells Fargo and its registered representatives did not review the private placement memoranda (PPMs) for the investments and the extensive risk disclosures in those documents. Instead, they relied almost exclusively on the credit ratings of these products despite various warnings against such over-reliance in the PPM and elsewhere. Wells Fargo also failed to establish any procedures to ensure that its personnel adequately reviewed and understood the nature and risks of these commercial paper programs. Wells Fargo and its registered representatives failed to have a reasonable basis for their recommendations. They also failed to disclose to their customers the risks associated with the complex SIV-issued ABCP investments, including the nature and volatility of the underlying assets. A number of customers purchased SIV-issued ABCP as a result of Wells Fargo's recommendations, and many of them ultimately suffered substantial losses after three SIV-issued ABCP programs defaulted in 2007. The SEC also charged former vice president Shawn McMurtry for his improper sale of SIV issued ABCP. McMurtry exercised discretionary authority in violation of Wells Fargo's internal policy and selected the particular issuer of ABCP for one longstanding municipal customer. McMurtry did not obtain sufficient information about the investment and relied almost entirely upon its credit rating. Wells Fargo paid a $6.5 million penalty, $65,000 in disgorgement, and $16,571.96 in prejudgment interest. McMurtry agreed to be suspended from the securities industry for six months and pay a $25,000 penalty.

In September, the SEC charged Goldman, Sachs & Co. and one of its former investment bankers, Neil Morrison, with violations of various MSRB rules for undisclosed "in-kind" non-cash campaign contributions to then-Massachusetts state treasurer Timothy P. Cahill while he was a candidate for governor.[65] Morrison was a vice president in the firm's Boston office and allegedly solicited underwriting business from the Massachusetts treasurer's office beginning in July

63 *SEC v. Kwame Kilpatrick, et al., Lit. Rel. No. 22362 (May 9, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22362.htm*

64 *In the Matter of Wells Fargo Brokerage Services, LLC, n/k/a Wells Fargo Securities, LLC and Shawn Patrick McMurtry, Exchange Act Rel. No. 67649 (August 14, 2012) http://www.sec.gov/litigation/admin/2012/33-9349.pdf*

65 *In the Matter of Goldman, Sachs & Co., Exchange Act Rel. No. 67934 (September 27, 2012) http://www.sec.gov/litigation/admin/2012/34-67934.pdf; In the Matter of Neil M.M. Morrison, Exchange Act Rel. No. 67935 (September 27, 2012) http://www.sec.gov/litigation/admin/2012/34-67935.pdf*

2008. Morrison also was substantially engaged in working on Cahill's political campaigns from November 2008 to October 2010. Morrison at times conducted campaign activities from the Goldman Sachs office during work hours and used the firm's phones and e-mail. Morrison's use of Goldman Sachs work time and resources for campaign activities constituted valuable in-kind campaign contributions to Cahill that were attributable to Goldman Sachs, which disqualified the firm from engaging in municipal underwriting business with certain Massachusetts municipal issuers for two years after the contributions. In addition to his direct campaign work for Cahill, Morrison made an indirect cash contribution to Cahill by giving cash to a friend who then wrote a check to the Cahill campaign. Morrison's campaign work and his indirect financial contribution created a conflict of interest that was not disclosed by Goldman Sachs in the relevant municipal securities offerings in violation of pay-to-play rules. Nevertheless, Goldman Sachs subsequently participated in 30 prohibited underwritings with Massachusetts issuers and earned more than $7.5 million in underwriting fees. Goldman settled the charges and paid $7,558,942 in disgorgement, $670,033 in prejudgment interest, and a $3.75 million penalty, which is the largest ever imposed by the SEC for MSRB pay-to-play violations.

That same month, the SEC charged Bruce Cole, former CEO and chairman of Mamtek US, for executing a scheme to defraud investors and making material misrepresentations and omissions in connection with the July 2010 offer and sale of $39 million of appropriations credit bonds backed by the City of Moberly, Missouri.[66] The bond offering was intended to finance a sucralose processing plant in Moberly that Mamtek would construct and operate. The SEC alleged that Cole executed his fraud by directing unsuspecting Mamtek employees to take actions that diverted over $900,000 in bond proceeds for his and his wife's personal use and by misleading city officials and bondholders about the use of those proceeds. Prior to the close of the bond offering, Cole directed Mamtek employees and consultants to create false documentation for a nonexistent company to justify fictitious expenses for the sucralose project. He then instructed Mamtek employees to wire his wife $900,000 in bond proceeds, which were used to pay, among other things, their mortgage, credit card debt, homeowners and auto insurance, and household employees, in part, under the false pretense that she was an agent of the sham company. Finally, as a precondition to the issuance of the bonds, Cole signed a certificate representing certain portions of the Official Statement delivered to bondholders for the $39 million offering were not false or misleading. However, at the time that Cole signed the document, he had already directed the creation of the false documentation and had made preliminary plans to divert and misuse the bond proceeds, rendering his representation in the closing certificate false. In doing so, he misrepresented the use of bond proceeds and the accuracy of the Official Statement.

Actions Involving Cases in New Areas

In April, the SEC charged Egan-Jones Ratings Company (EJR) and Sean Egan, its owner and president, for material misrepresentations and omissions in the company's July 2008 application to register as a Nationally Recognized Statistical Rating Organization (NRSRO) for issuers of asset-backed securities (ABS) and Government securities.[67] EJR and Egan also were charged with material misrepresentations in other submissions furnished to the SEC and violations of record-keeping and conflict-of-interest provisions governing NRSROs. According to the allegations, EJR falsely stated that as of the date of its 2008 application it had 150 outstanding ABS issuer ratings and 50 outstanding Government issuer ratings. EJR further falsely stated in its 2008 application that it had been issuing credit ratings in the ABS and Government categories as a credit rating agency on a continuous basis since 1995. In fact, at the time of its July 2008 application, EJR had not issued — that is, made available on the Internet or through another readily accessible means — any ABS or government issuer ratings, and therefore did not meet the requirements for registration as an NRSRO in these categories. EJR continued to make material misrepresentations regarding its experience rating asset-backed and Government securities in subsequent annual certifications furnished to the SEC. EJR also made other misstatements and omissions in submissions to the

[66] *SEC v. Bruce Cole, et al., Lit. Rel. No. 22484 (September 18, 2012) http://www.sec.gov/litigation/litreleases/2012/lr22484.htm*

[67] *In the Matter of Egan-Jones Ratings Company, et al., Exchange Act Rel. No. 66854 (April 24, 2012) http://www.sec.gov/litigation/admin/2012/34-66854.pdf*

SEC by providing inaccurate certifications from clients, failing to disclose that two employees had signed a code of ethics different than the one EJR disclosed, and inaccurately stating that EJR did not know if subscribers were long or short a particular security. In addition, EJR purportedly violated other provisions of Commission rules governing NRSROs. EJR failed to enforce its policies to address conflicts of interest arising from employee ownership of securities, and allowed two analysts to participate in determining credit ratings for issuers whose securities they owned. EJR also failed to make and retain certain required records, including a detailed record of its procedures and methodologies to determine credit ratings and e-mails regarding its determination of credit ratings. Finally, Egan provided inaccurate information that was included in EJR's applications and annual certifications. He signed the submissions and certified that the information provided in them was "accurate in all significant respects," when he knew that it was not. Egan also failed to ensure EJR's compliance with the recordkeeping requirements and conflict-of-interest provisions. The action against EJR and Egan is continuing.

That same month, the SEC also charged that Goldman, Sachs & Co. lacked adequate policies and procedures to address the risk that during weekly "huddles," the firm's analysts could share material, nonpublic information about upcoming research changes.[68] Huddles were a practice where Goldman's stock research analysts met to provide their best trading ideas to firm traders and later passed them on to a select group of top clients. The SEC found that from 2006 to 2011, Goldman held weekly huddles sometimes attended by sales personnel in which analysts discussed their top short-term trading ideas and traders discussed their views on the markets. In 2007, Goldman began a program known as the Asymmetric Service Initiative (ASI) in which analysts shared information and trading ideas from the huddles with select clients. These programs created a serious risk that Goldman's analysts could share material, nonpublic information about upcoming changes to their published research with ASI clients and the firm's traders. These risks were increased by the fact that many of the clients and traders engaged in frequent, high-volume trading. Despite those risks, Goldman failed to establish adequate policies or adequately enforce and maintain its existing policies to prevent the misuse of material, nonpublic information about upcoming changes to its research. Goldman's surveillance of trading ahead of research changes — both in connection with huddles and otherwise — was deficient. Goldman settled the charges and paid a $22 million penalty. Goldman also agreed to be censured, to be subject to a cease-and-desist order, and to review and revise its written policies and procedures to correct the deficiencies identified by the SEC.

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[68] *In the Matter of Goldman, Sachs & Co., Exchange Act Rel. No. 66791 (April 12, 2012) http://www.sec.gov/litigation/admin/2012/34-66791.pdf*

Appendix C: SEC Divisions and Offices

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Appendix D: Glossary of Selected Terms

Advisers Act

The Investment Advisers Act of 1940 is a U.S. Federal law that was created to regulate the actions of investment advisers.

Agency Financial Report (AFR)

An annual requirement that provides financial and high-level performance results that enable the President, Congress, and the public to assess an agency's accomplishments each fiscal year (October 1 through September 30). This report includes audited financial statements and provides an overview of an agency's programs, accomplishments, challenges, and management's accountability for entrusted resources. The report is prepared in accordance with the requirements of Office of Management and Budget (OMB) Circular A-136, Financial Reporting Requirements. Under Circular A-136, agencies may prepare an Agency Financial Report and Annual Performance Report, or may combine these two reports into the Performance and Accountability Report.

Annual Performance Report (APR)

A report that outlines goals and intended outcomes of an agency's programs and initiatives. This report provides program performance and financial information that enables the President, Congress, and the public to assess an agency's performance and accountability over entrusted resources.

Asset

An asset is a resource that embodies economic benefits or services that the reporting entity controls.

Breaking the Buck

Money market funds seek stability and security with the goal of never losing money and keeping the fund net asset value (NAV) at $1. This $1 NAV baseline gives rise to the phrase "breaking the buck," meaning that if the value falls below the $1 NAV level, a portion of the original investment has been lost.

Statement of Cash Flows

Reports a company's inflows and outflows of cash over time by classification.

Cause Examinations

An examination that results from investor complaints, credible tips, media reports, or the SEC's own risk assessment process for identifying questionable investment-related activity (See Sweep Examinations). A Cause Exam is the highest priority Securities and Exchange Commission (SEC) exam.

Clawback Policies

Under the Dodd-Frank Act, all listed companies will eventually be required to institute a mechanism for reclaiming executive pay that had been granted under misstated earnings.

Collateralized Debt Obligation (CDO)

A type of structured asset-backed security (ABS) with multiple "tranches" that are issued by special purpose entities and collateralized by debt obligations including bonds and loans. Each tranche offers a varying degree of risk and return so as to meet investor demand.

Crowd Funding/Sourcing

In the JOBS Act, a new means of raising capital enabling the raising of small amounts of equity capital without having to register with the SEC.

Deposit Fund

Consists of funds that do not belong to the Federal Government, such as disgorgement, penalties, and interest collected and held on behalf of harmed investors, registrant monies held temporarily until earned by the SEC, and collections awaiting disposition or reclassification.

Derivative

A contract between two parties that specifies conditions (dates, resulting values of the underlying variables, and notional amounts) under which payments are to be made between the parties.

Disgorgement

A repayment of funds received or losses forgone, with interest, as a result of illegal or unethical business transactions. Disgorged funds are normally distributed to those affected by the action, but in certain cases may be deposited in the General Fund of the Treasury.

Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)

A Federal law that regulates the U.S. financial industry. The legislation, enacted in July 2010, created new financial regulatory processes that enforce transparency and accountability while implementing rules for consumer protection.

Earmarked Funds

Accounts containing specifically identified revenues, often supplemented by other financing sources, that are required by statute to be used for designated activities, benefits or purposes, and must be accounted for separately from the Government's general revenues. For example, Investor Protection Fund resources are earmarked and may only be used for the purposes specified by the Dodd-Frank Act.

Entity Assets

Assets that an agency is authorized to use in its operations. For example, the SEC is authorized to use all funds in the Investor Protection Fund for its operations.

Entity Accounts Receivable

Monies owed to the SEC generated from securities transaction fees and filing fees paid by registrants.

Exchange Revenue

Exchange revenues are inflows of earned resources to an entity. Exchange revenues arise from exchange transactions, which occur when each party to the transaction sacrifices value and receives value in return. Examples include the sale of goods and services, entrance fees and most interest revenue.

Family Offices

A family office, or single family office (SFO), is a private company that manages investments and trusts for a single wealthy family. The company's financial capital is the family's own wealth, often accumulated over many family generations.

Federal Accounting Standards Advisory Board (FASAB)

A U.S. Federal advisory committee sponsored by the Secretary of the Treasury, the Director of the Office of Management and Budget, and the Comptroller General of the United States, whose mission is to develop generally accepted accounting principles (GAAP) for the United States Government.

Federal Information Security Management Act (FISMA)

A law that requires Federal agencies to conduct annual assessments of their information security and privacy programs, develop and implement remediation efforts for identified weaknesses and vulnerabilities, and report on compliance to OMB.

Financial Industry Regulatory Authority, Inc. (FINRA)

A private corporation that acts as a self-regulatory organization (SRO). FINRA is the successor to the National Association of Securities Dealers, Inc. (NASD) and is a non-governmental organization that performs financial regulation of member brokerage firms and exchange markets. The Government organization which acts as the ultimate regulator of the securities industry, including FINRA, is the SEC.

Financial Stability Oversight Board (FSOB)

A unit of the U.S. Department of the Treasury established by section 104 of the Emergency Economic Stabilization Act of 2008 (EESA) to help oversee the Troubled Assets Relief Program (TARP) and other emergency authorities and facilities granted to the Secretary of the Treasury under the EESA to help restore liquidity and stability to the U.S. financial system.

Frequency Votes

Shareholder advisory votes on compensation at public companies' annual shareholder meetings, required under the Dodd-Frank Act. One of these votes allows shareholders to select the desired frequency of Say-on-Pay votes. Under this frequency vote, sometimes called "Say When on Pay," shareholders may express a non-binding preference for whether Say-on-Pay votes should be held on an annual, biennial, or triennial basis. After the annual meeting, the company will be required to report on the frequency with which it will actually hold Say-on-Pay votes, in light of the results of the shareholder vote.

Fund Balance with Treasury (FBWT)

A Federal entity's fund balance with Treasury (FBWT) is the amount of funds in the entity's accounts with Treasury for which the entity is authorized to make expenditures and pay liabilities and that have not been invested in Federal securities.

Fund of Funds Arrangements

The ability of an investment company (Fund) to invest in shares of another fund.

General Funds – Salaries and Expenses

Appropriations by Congress that are used to carry out the agency's mission and day to day operations that may be used in accordance with spending limits established by Congress.

Generally Accepted Accounting Principles (GAAP)

Framework of accounting standards, rules, and procedures defined by the professional accounting industry. The Federal Accounting Standards Advisory Board (FASAB) is the body designated by the American Institute of Certified Public Accounting (AICPA) as the source of GAAP for Federal reporting entities.

Imputed Financing

Financing provided to the reporting entity by another Federal entity covering certain costs incurred by the reporting entity. For example, some Federal employee retirement benefits are paid by the Federal Government's central personnel office, the Office of Personnel Management. The SEC recognizes a financing source and corresponding expense to represent its share of the cost of providing pension and post-retirement health and life insurance benefits to all eligible SEC employees.

Insider Trading

The buying or selling of a security by someone who has access to material, nonpublic information about the security.

Intragovernmental Costs

Costs that arise from the purchase of goods and services from other components of the Federal Government.

Investor Protection Fund

A fund established by the Dodd-Frank Act to pay awards to whistle-blowers. The program requires the Commission to pay an award, under regulations prescribed by the Commission and subject to certain limitations, to eligible whistleblowers who voluntarily provide the Commission with original information about a violation of Federal securities laws that leads to the successful enforcement of a covered judicial or administrative action, or a related action.

Issuer-Pay Model

Model used since the 1970s whereby credit agencies were paid fees by the same firms they were responsible for impartially rating (see Subscriber-Pay Model).

Liability

A liability is a present obligation of the reporting entity to provide assets or services to another entity at a determinable date, when a specified event occurs, or on demand.

Limit Up-Limit Down Plan

A one-year pilot program to protect equity markets from volatile price swings which would pause trading.

Market Based Treasury Securities

Debt securities that the U.S Treasury issues to Federal entities without statutorily determined interest rates.

Microcap Securities

Low priced stocks issued by the smallest of companies.

Miscellaneous Receipt Account

A fund used to collect non-entity receipts from custodial activities that the SEC cannot deposit into funds under its control or use in its operations. These amounts are forwarded to the General Fund of the Treasury and are considered to be non-entity assets of the SEC.

The Municipal Securities Rulemaking Board (MSRB)

The Board that writes investor protection rules and other rules regulating broker-dealers and banks in the U.S. municipal securities market, including tax-exempt and taxable municipal bonds, municipal notes, and other securities issued by states, cities, and counties or their agencies to help finance public projects or for other public policy purposes.

NASDAQ

The NASDAQ Stock Market, also known as simply NASDAQ, is an American stock exchange. NASDAQ originally stood for National Association of Securities Dealers Automated Quotations. It is the second-largest stock exchange by market capitalization in the world, after the New York Stock Exchange.

Non-Entity Assets

Those assets that are held by an entity but are not available to the entity. Examples of non-entity assets are disgorgement, penalties, and interest collected and held on behalf of harmed investors.

Office of Management and Budget (OMB) Circular A-123

Defines management's responsibilities for internal financial controls in Federal agencies.

Office of Management and Budget (OMB) Circular A-136

Establishes a central point of reference for all Federal financial reporting guidance for Executive Branch departments, agencies, and entities required to submit audited financial statements, interim financial statements, and Performance and Accountability Reports (PAR), and Agency Financial Reports (AFR) under the Chief Financial Officers Act of 1990, the Accountability of Tax Dollars Act of 2002, and Annual Management Reports under the Government Corporations Control Act.

Performance and Accountability Reports (PAR)

An annual report that provides program performance and financial information that enables Congress, the President, and the public to assess an agency's performance and accountability over entrusted resources.

Performance Indicators Results Summary

A summary of performance by outcome within each strategic goal.

Pay to Play Schemes

Payments or gifts made to influence awarding of lucrative contracts for securities underwriting business.

Proxy Plumbing Concept

A concept release seeking public comment on the U.S. proxy system and asking whether rule revisions should be considered to promote greater efficiency and transparency. The U.S. proxy (voting) system is set to undergo a comprehensive review for the first time in nearly 30 years.

Public Company Accounting Oversight Board (PCAOB)

A nonprofit corporation established by Congress to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. The PCAOB also oversees the audits of broker-dealers, including compliance reports filed pursuant to Federal securities laws, to promote investor protection.

Pump and Dump Schemes

A form of micro stock fraud involving artificially inflating the price of an owned stock through false and misleading positive statements.

Regulation National Market System (NMS)

Regulation promulgated by SEC representing a series of initiatives designed to modernize and strengthn the national market system for equity securities.

Reserve Fund

A fund established by the Dodd-Frank Act that may be used by the SEC to obligate amounts up to a total of $100 million in one fiscal year as the SEC determines it necessary to carry out its functions.

Resource Extraction Rule

As implemented by Dodd-Frank, the resource extraction rule requires disclosure of payments of $100,000 or more made to governments for the commercial development of oil, natural gas, or minerals. This rule applies to U.S. and foreign companies that are 1) engaged in the commercial development of oil, natural gas, or minerals, and 2) required to file annual reports with the SEC.

Reverse Merger

Acquisition of a public company by a private company so the private company can bypass the complex process of going public.

Section 31 Fees

Transaction fees paid to the SEC based on the volume of securities that are sold on various markets. Under Section 31 of the Securities Exchange Act of 1934, self-regulatory organizations (SROs) – such as the Financial Industry Regulatory Authority (FINRA) and all of the national securities exchanges (including the New York Stock Exchange) – must pay transaction fees to the SEC based on the volume of securities that are sold on their markets. These fees recover the costs incurred by the Government, including the SEC, for supervising and regulating the securities markets and securities professionals.

Securities Exchange Act of 1934 (Exchange Act)

A law governing the secondary trading of securities (stocks, bonds, and debentures) in the United States. It was this piece of legislation that established the Securities and Exchange Commission. The Exchange Act and related statutes form the basis of regulation of the financial markets and their participants in the United States.

Self-Regulatory Organization (SRO)

An organization that exercises some degree of regulatory authority over an industry or profession. The regulatory authority could be applied in addition to some form of Government regulation, or it could fill the vacuum of an absence of Government oversight and regulation. The ability of an SRO to exercise regulatory authority does not necessarily derive from a grant of authority from the Government.

Shadow NAV (Net Asset Value)

The mark-to-market expression of the value of money market Fund shares using the market value of the Fund's portfolio holdings. Money market funds target a Stable NAV of $1.00 per share. Since the value is based on prevailing market prices, which are constantly changing, shadow NAV may fluctuate slightly above or below $1.00, but would be expected to round to $1.00. Shareholders' equity – sometimes called capital or net worth, it's the value of the firm that would be left if a company sold all of its assets and paid off all of its liabilities.

Shelf Regulation

A regulation that a corporation can evoke to comply with SEC registration requirements for a new stock offering up to three years before doing the actual public offering. However, the corporation must still file the required annual and quarterly reports with the SEC.

Strategic Plan

A report initially required by the Government Performance and Results Act (GPRA) that defines the agency mission, long-term goals, strategies planned, and the approaches it will use to monitor its progress in addressing specific national problems, needs, challenges, and opportunities related to its mission. The Plan also presents general and long term goals the agency aims to achieve, what actions the agency will take to realize those goals, and how the agency will deal with challenges and risks that may hinder achieving result. Requirements for the Strategic Plan are presented in OMB Circular A-11, Preparation, Submission and Execution of the Budget.

Subscriber-Pay Model

Before the 1970s, the credit ratings industry operated under an investor-pay model. Investors subscribed to ratings released by the agencies, and these subscription revenues were the main source of income for the rating agencies (see Issuer-Pay Model).

Sweep Examinations

An examination performed by the SEC when it identifies a pattern of emerging or resurgent risks based on routine exams or its internal risk assessment process. These exams focus on the specific risk identified and the sweep will typically involve several firms to determine how widespread is the targeted risk (see Cause Examinations).

U.S. Commodity Futures Trading Commission (CFTC)

An independent agency of the U.S. Government that regulates futures and option markets.

U.S. Exchanges

A place (physical or virtual) where stock traders come together to decide on the price of securities.

U.S. Securities and Exchange Commission (SEC)

The SEC is an independent agency of the U.S. Government established pursuant to the Securities Exchange Act of 1934 (Exchange Act), charged with regulating the country's capital markets. It is charged with protecting investors, maintaining fair, orderly and efficient markets; and facilitating capital formation.

Appendix E: Acronyms

ABCP	Asset-Backed Commercial Paper
ABS	Asset-Backed Securities
ACAP	American Physicians Capital Inc.
ADA	Antideficiency Act
AFR	Agency Financial Report
AICPA	American Institute of Certified Public Accountants
API	Aberrational Performance Inquiry
APR	Annual Performance Report
ASI	Asymmetric Service Initiative
BD	Broker-Dealer
CDO	Collateralized Debt Obligation
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CFR	Code of Federal Regulations
CFTC	Commodities Futures Trading Commission
CMBS	Commercial Mortgage-Backed Securities
COOP	Continuity of Operations Plan
COSRA	Council of Securities Regulators of the Americas
CSKI	China Sky One Medical Inc.
CSRS	Civil Service Retirement System
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
DOJ	Department of Justice
DOL	U.S. Department of Labor
DRP	Disaster Recovery Plan
EDGAR	Electronic Gathering, Analysis and Retrieval
EESA	Emergency Economic Stabilization Act of 2008
EJR	Egan-Jones Ratings Company
EU	European Union
Exchange Act	Securities Exchange Act of 1934
Fannie Mae	Federal National Mortgage Association
FASAB	Federal Accounting Standards Advisory Board
FBWT	Fund Balance with Treasury
FECA	Federal Employees' Compensation Act
FEGLIP	Federal Employees Group Life Insurance Program
FEHBP	Federal Employees Health Benefits Program
FERS	Federal Employees Retirement System
FFMIA	Federal Financial Management Improvement Act
FINRA	Financial Industry Regulatory Authority
FISMA	Federal Information Security Management Act
FLRA	Federal Labor Relations Authority
FMFIA	Federal Managers' Financial Integrity Act of 1982
FMOC	Financial Management Oversight Committee
FOIA	Freedom of Information Act
Freddie Mac	Federal Home Loan Mortgage Corporation
FSIO	Financial Systems Integration Office
FSOB	Financial Stability Oversight Board
FSSP	Federal Shared Services Provider
FTC	Federal Trade Commission
FTE	Full-Time Equivalents
FY	Fiscal Year
GAAP	Generally Accepted Accounting Principles
GAO	Government Accountability Office
GPRA	Government Performance and Results Act
GSA	U.S. General Services Administration
GSS	General Support System
ICFR	Internal Control over Financial Reporting
IM	Division of Investment Management

IOSCO	International Organization of Securities Commissions
IPERA	Improper Payments Elimination and Recovery Act of 2010
IPF	Investor Protection Fund
IPIA	Improper Payments Information Act of 2002
IPO	Initial Public Offering
JOBS Act	Jumpstart Our Business Startups Act
LAA	Latin American Association
LBP	Liabilities to Benefits Paid Ratio
MALDEF	Mexican American Legal Defense and Education Fund
MD&A	Management's Discussion and Analysis
MSIM	Morgan Stanley Investment Management
MSRB	Municipal Securities Rulemaking Board
NASAA	North American Securities Administrators Association
NASD	National Association of Securities Dealers
NAV	Net Asset Value
NEP	National Examination Program
NIST	National Institute of Standards and Technology
NRSRO	Nationally Recognized Statistical Rating Organization
NTEU	National Treasury Employees Union
NYSE	New York Stock Exchange
OA	Office of Acquisitions
OCIE	Office of Compliance Inspections and Examinations
OGC	Office of the General Counsel
OIA	Office of International Affairs
OIG	Office of Inspector General
OIT	Office of Information Technology
OMB	Office of Management and Budget
OPM	Office of Personnel Management
OTC	Over-the-Counter
PAR	Performance and Accountability Report
PCAOB	Public Company Accounting Oversight Board
PIA	Privacy Impact Assessment
PIV	Personal Identity Verification
PPM	Private Placement Memorandum
RAS	Office of Risk Analysis and Surveillance
REG	Office of Risk and Examination Group
Reserve Fund	Securities and Exchange Commission Reserve Fund
RMBS	Residential Mortgage-Backed Securities
RSFI	Division of Risk, Strategy and Financial Innovation
S/L	Straight-Line
SBR	Statement of Budgetary Resources
SEC	U.S. Securities and Exchange Commission
SFO	Single Family Office
SIPA	Securities Investor Protection Act of 1970
SIPC	Securities Investor Protection Corporation
SIV	Structured Investment Vehicle
SRO	Self-Regulatory Organization
SSP	System Security Plan
STARS	Super Tracking and Reporting System
TARP	Troubled Assets Relief Program
TCR	Tips, Complaints and Referrals
TDF	Target Date Funds
TM	Division of Trading and Markets
TRS	Total Return Swaps
TSP	Thrift Savings Plan

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