

# The SEC's Intensifying Focus on Risk: Implications for the Investment Management Industry

By Patricia C. Foster



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In a noteworthy work published in 2007, author Richard Bookstaber recounts his experience with two financial crises of the late twentieth century – the 1987 stock market crash and the Long-Term Capital Management hedge fund debacle that occurred 11 years later.<sup>1</sup>

My actions seemed insignificant at the time, and certainly the consequences were unintended. You don't deliberately obliterate hundreds of billions of investor money. And that is the heart of this book – it is going to happen again. The financial markets that we have constructed are now so complex, and the speed of transactions so fast that apparently isolated actions and even minor events can have catastrophic consequences.<sup>2</sup>

Just one year later, the United States found itself in the midst of the most significant financial crisis since the Great Depression of the 1930s. Domestic and international markets were in free fall, and Bookstaber's prescient commentary on the complexity of the financial markets had begun to resonate with industry participants and perhaps even regulators. By November of 2009, Bookstaber had been recruited to join the SEC's newly created Division of Risk, Strategy and Financial Innovation as Senior Policy Advisor to the Director. In retrospect, it appears that the colorful book jacket chosen for his book, which depicts the legendary Icarus plummeting from the sky, may have signaled the beginning of an intensified regulatory focus on risk management.<sup>3</sup>

This article provides an overview of recent regulatory developments that illustrate the SEC's intensifying focus on the importance of effective risk management in the investment management industry. It

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also explores the significant role of governance in connection with a firm's risk management program and importance of government policy in connection with systemic risk analysis. This intensifying focus on risk management is readily apparent from a review of recent regulatory initiatives, industry studies, speeches made by regulators and new disclosure requirements.

## **The SEC's New Division of Risk, Strategy and Financial Innovation**

On September 16, 2009, the Commission announced the establishment of the Division of Risk, Strategy and Financial Innovation (Risk Fin), its first new division in 37 years. The new division, which combines the Office of Economic Analysis (OEA), the Office of Risk Assessment (ORA), and certain other functions, is poised to provide the Commission with sophisticated analyses that integrate economic, financial and legal disciplines. The division's responsibilities cover three broad areas: risk and economic analysis; strategic research; and financial innovation.<sup>4</sup> Specifically, the division performs all of the functions previously performed by OEA and ORA in addition to the following: (1) strategic and long-term analysis; (2) identification of new developments and trends in financial

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markets and systemic risk; (3) formulation of recommendations as to how these new developments and trends affect the Commission's regulatory activities; (4) research and analysis in furtherance and support of the functions of the Commission and its divisions and offices; and (5) delivery of training on

new developments and trends and other matters.

Risk Fin is, in essence, the Commission's "think tank." We can expect that Risk Fin's interdisciplinary approach will inform a spectrum of regulatory activities, including policymaking, rulemaking, examinations and enforcement. Regulators recognize that it is no longer 1950, and that investment portfolios may include financial instruments that are much more complex than stocks and bonds. As explained below, we have already seen indications that the inclusion of industry professionals who understand the complexities of the financial markets is assisting the Commission in identifying and addressing innovative developments that may pose systemic risk.

## **The SEC's Investment Adviser Examination Program**

The Commission's Office of Compliance Inspections and Examinations (OCIE) examines registered investment advisers' books, records and activities. These examinations are designed to (1) improve compliance; (2) prevent fraud; (3) monitor risk; and (4) inform regulatory policy. A review of the report of the SEC's Office of the Inspector General (OIG) issued in November 2009 and the report of the SEC's Division of Investment Management (IM) issued in January 2011 provides important insights about the examination program. The remarks of Carlo di Florio, Director of OCIE at a recent industry conference provide additional insights about the agency's expectations of investment advisers relating to risk management.

## **Reports of the Office of the Inspector General**

OCIE had been utilizing a risk-based examination process for a number of years when the Bernard Madoff fraud came to light in late 2008. On August 31, 2009, OIG issued a comprehensive report consisting of over 450 pages, entitled *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme*.<sup>5</sup> The investigation found that the Commission received more than ample information in the form of detailed and substantive complaints over a period of many years to warrant a thorough and comprehensive examination and/or investigation

of Bernard Madoff (Madoff) and Bernard Madoff Investment Securities, LLC (BMIS). The investigation also found that, despite three examinations and two investigations of Madoff and/or BMIS, neither a thorough and competent examination nor a thorough and competent investigation had ever been performed, and the Commission never identified the large-scale Ponzi scheme that Madoff had operated for decades.

On November 19, 2009, OIG issued another report detailing the results of its review of the Commission's process for selecting investment advisers and investment companies for examination.<sup>6</sup> The review was conducted by OIG as part of its continuous efforts to assess management of the Commission's programs and operations. The report included 11 recommendations that were formulated to strengthen the Commission's process for selecting investment advisers and investment companies for examination. OCIE concurred with each of the 11 recommendations. Notably, a number of the recommendations relate to the identification of advisory firms that may pose greater risk. For example, the report states that OCIE should assign progressively higher risk weightings to firms that have greater assets under management and to firms that serve a larger number of clients.

Two of the 11 recommendations relate specifically to OCIE's process for creating or adjusting a risk rating for an investment adviser.

- Recommendation 1 states that OCIE should implement a procedure requiring, as part of its process for creating a risk rating for an investment adviser, that OCIE staff perform a search of Commission data bases containing information about past examinations, investigations and filings related to the investment adviser.
- Recommendation 2 states that OCIE should change the risk rating of an investment adviser based on pertinent information garnered from all Divisions and Offices of the Commission, including information from OCIE examinations and Enforcement investigations, regardless of whether the information was learned during an examination conducted to look specifically at the firm's investment advisory business.

Three of the 11 recommendations relate to procedures for the evaluation of negative and/or inconsistent information received about an investment adviser.

- Recommendation 4 states that OCIE should establish a procedure to thoroughly evaluate negative information that it receives about an investment adviser and use this information to determine when it is appropriate to conduct a cause examination of an investment adviser, and that OCIE should ensure that its procedure provides for timely opening of a cause examination.
- Recommendation 5 states that when OCIE becomes aware of negative information pertaining to an investment adviser, OCIE should examine the investment adviser's Form ADV filings, and document and investigate discrepancies existing between the adviser's Form ADV and information that OCIE previously learned about the registrant.
- Recommendation 6 states that OCIE should establish a procedure to thoroughly evaluate an investment adviser's Form ADVs when OCIE becomes aware of issues or problems with an investment adviser. OCIE should document areas where it believes a Form ADV contains false information, and initiate appropriate action, such as commencing a cause examination.

These recommendations reflect a heightened concern by regulators about the potential for high risk and/or fraudulent advisory activities. Industry participants can expect that OCIE's acceptance of these recommendations will result in modifications to the examination process.

## Staff Study on Enhancing Investment Adviser Examinations

In January 2011, the staff of IM released its *Study on Enhancing Investment Adviser Examinations* (Study) as required by Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).<sup>7</sup> The Study was intended to review and analyze the need for enhanced examination and enforcement resources for investment advisers. The Study discusses the process by which OCIE examines registered investment advisers' books, records and activities; analyzes the number and frequency of examinations of registered investment advisers over a period of six years (October 1, 2004 – September 30, 2010); analyzes projected changes in the number of registered investment advisers and OCIE staff after the enactment of the Dodd-Frank Act

and how the changes are expected to affect the examinations of registered investment advisers; and discusses options that Congress should consider in order to strengthen the Commission's investment adviser examination program.

The Study concludes that the registered investment adviser examination program faces significant capacity challenges, and that, in order to meet these challenges, the program requires a source of funding that is sufficiently stable to prevent examination resources from periodically being outstripped by growth in the number of registered investment advisers (i.e., it requires resources that are scalable to any future increase or decrease in the number of registered investment advisers).

The Study identifies three possible approaches for Congress to consider: (1) the imposition of "user fees" on SEC-registered investment advisers that could be retained by the Commission to fund the investment adviser examination program; (2) the authorization of one or more SROs to examine, subject to SEC supervision, all SEC-registered investment advisers; or (3) the authorization of the Financial Industry Regulatory Authority (FINRA) to examine dual registrants for compliance with the Advisers Act.

While a comparison of these approaches is beyond the scope of this article, it is important to note that the Study discusses the imposition of user fees as an approach that could provide scalable resources to support the Commission's investment adviser examination program. The Study explains that the fees collected from investment advisers would be available to the Commission without further appropriation, would be used solely to fund the investment adviser examination program and would be set at a level designed to achieve an acceptable frequency of examinations. The user fee option is presented as one that, as a result of stable resources, could provide the program with increased flexibility to address emerging risks associated with investment advisers, and to direct staffing and strategic responses that may help address critical issues. Specifically, the Study states that "the examination program would be in a better position, once risks are identified, to allocate necessary revenues, including adding staff with appropriate experience and developing specific training for existing staff, in order to mitigate the impact of such risks."<sup>8</sup>

Although Commissioner Elisse B. Walter voted to release the study to Congress, she also issued a statement outlining her concerns about the ability of the Commission to fulfill its examination mandate with respect to investment advisers, unless significant changes are made (Statement).<sup>9</sup> Pointing to the significant decreases in the number and frequency of examinations during the past five years and the substantial challenges faced by the agency in its efforts to increase the number and frequency of examinations, the Statement emphasizes the severity of the current resource problem and the necessity of a timely solution. The Statement also notes Commissioner Walter's preference for a study that would have resulted in more precise and objective recommendations and a more balanced presentation of the three options under consideration.<sup>10</sup>

### **Perspective Shared by Carlo V. di Florio on the National Exam Program**

Speaking at the IA Watch Annual IA Compliance Best Practices Seminar in Washington, D.C. on March 21, 2011, Carlo di Florio, Director of OCIE, provided an overview of changes in what he referred to as the "National Exam Program" and identified key exam focus areas for registered investment advisers.<sup>11</sup> He began by identifying the new division of Risk, Strategy and Financial Innovation as a "great partner" for OCIE, noting that the new division is raising OCIE's knowledge and awareness of new and emerging risks. He stated that, like industry participants, OCIE is trying to allocate its precious, limited resources to their highest and best use by taking a "risk-focused" strategy.<sup>12</sup>

Director di Florio stated that OCIE is implementing many reforms that are designed to improve consistency, effectiveness and efficiency of the National Exam Program. He said that the cornerstone of the program is a national governance model that includes regional leadership in strategic planning, policy development and performance management decisions. Director di Florio outlined the four key objectives that support OCIE's mission to protect investors, maintain market integrity and facilitate capital formation. These objectives involve:

- Improving industry compliance with the securities laws as well as industry risk management

and compliance practices through exams and communication with industry.

- Identifying and preventing fraud through risk-targeted exams and better coordination with the Division of Enforcement in identifying, investigating and preventing fraud.
- Monitoring new and emerging risks to investor protection and market integrity through joint initiatives with OCIE's policy divisions and the Division of Risk, Strategy and Financial Innovation. This objective includes the development of new risk assessment and surveillance models and risk analytics that will permit OCIE to target the highest risk firms, practices and trends.
- Informing policy as the eyes and ears of the SEC in the field, through involvement in the rule-making process, and with dedicated policy support teams on key initiatives.

Director di Florio noted that OCIE has a new Risk Analysis and Surveillance Unit that is expected to enhance OCIE's ability to identify the highest risk firms and the highest risk issues to focus on in connection with examinations of those firms.

It is clear that OCIE has embraced the concept of Enterprise Risk Management (ERM)<sup>13</sup> and that it expects that investment advisers will embrace the concept as well. Reflecting on the recent financial crisis, Director di Florio stated that the crisis revealed just how dramatically risk management failures can harm investors, jeopardize market integrity and hinder capital formation. He stated that the crisis also revealed the need for better oversight of risk at the board and senior management levels, and the need for stronger independence, standing and authority among a firm's internal risk management, control and compliance functions. Based on Director di Florio's remarks, investment advisers and investment companies can expect that OCIE will focus its exams on risk management within the context of the ERM framework of a firm in an effort to assess the firm's risk control environment (i.e., its system of checks and balances).

During the course of his remarks, Director di Florio stated that OCIE has identified seven specific focus areas for its investment adviser examinations: (1) valuation; (2) conflicts of interest; (3) portfolio management; (4) performance and advertising issues; (5) asset verification; (6)

risk governance; and (7) business continuity/disaster recovery. An eighth focus area identifies specific issues that OCIE is currently monitoring, such as use of social media and small niche investment products such as mutual funds and exchange-traded funds that provide exposure to asset classes that are subject to unusual or obscure risks. While each of the focus areas relates to specific risks attendant to the investment management industry, the risk governance focus is worthy of discussion because Director di Florio's recent remarks provide insights that may be important to investment advisers that have not yet adopted and implemented effective risk management programs. He stated that examiners will look at risk management practices and ask five questions about various policies, procedures and practices that comprise a firm's risk governance program:

- First, how do the business units of an entity ensure they are taking and managing risk effectively at the product and asset class level in accordance with the risk appetite and tolerances set by the board and senior management of the whole organization?
- Second, how are key risk management, control and compliance functions structured and resourced to ensure they are effectively embedded in the business process, while having the necessary independence, standing and authority to be effective in helping the organization identify, manage and mitigate risk?
- Third, how is senior management ensuring effective oversight of enterprise risk management and embedding risk management in key business processes, including strategic planning, capital allocation, performance management and compensation incentives?
- Fourth, how does the internal audit process independently verify and provide the board and senior management with assurance regarding the operating effectiveness of risk management, compliance and control functions?
- Finally, how is the board of directors (if one exists in the organization) staffed and structured to ensure that it can effectively set risk parameters, foster an effective risk management culture, oversee risk-based compensation systems and effectively oversee the risk profile of the firm?

## The Significant Role of Governance in Risk Management

Entrepreneurial risk-taking has traditionally been rewarded and celebrated. The emergence of the corporate form and the development of our capital markets have resulted in the creation of large enterprises that have created wealth for their various stakeholders. David Skeel, author of *Icarus in the Boardroom*,<sup>14</sup> who has studied the development of the corporation since the issuance of the earliest corporate charters in the United States, posits that everything changes when you put Icarus in the boardroom. He says that an “Icaran” executive who takes excessive or fraudulent risks with a large corporation may jeopardize the financial lives of thousands of employees, investors and suppliers.”<sup>15</sup> Skeel points to three factors that have been at the heart of a series of devastating crises over the past one hundred fifty years – excessive and sometimes fraudulent risks, competition and the increasing size and complexity of the corporation. Indeed, the confluence of these factors, together with the proliferation of extraordinarily complex unregulated financial products, aptly describes the causes of the financial crisis that occurred three years after Skeel’s book was published in 2005. *The Financial Crisis Inquiry Report* published in January 2011 and the *Report of the Senior Supervisors Group: Risk Management Lessons from the Global Banking Crisis of 2008* illustrate the importance of the role of governance in an effective risk management program.

## The Financial Crisis Inquiry Report

Among the conclusions of *The Financial Crisis Inquiry Report* published in January 2011 (Report)<sup>16</sup>, was the conclusion that dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of the global financial crisis of 2008.

There was a view that instincts for self-preservation inside major financial firms would shield them from fatal risk-taking without the need for a steady regulatory hand, which, the firms argued, would stifle innovation. Too many of these institutions acted recklessly, taking on too much risk, with too little capital, and with

too much dependence on short-term funding. In many respects, this reflected a fundamental change in these institutions, particularly the large investment banks and bank holding companies, which focused their activities increasingly on risky trading activities that produced hefty profits. They took on enormous exposures in acquiring and supporting subprime lenders and creating, packaging, repackaging and selling trillions of dollars in mortgage related securities, including synthetic financial products. Like Icarus, they never feared flying ever closer to the sun.<sup>17</sup>

## Report of the Senior Supervisors Group: Risk Management Lessons from the Global Banking Crisis of 2008

The Financial Stability Board (FSB) has commissioned a number of studies in recent years that are relevant to risk management programs in the financial services industry.<sup>18</sup> In *Risk Management Lessons from the Global Banking Crisis of 2008*, which was issued in October 2009, SSG identifies various deficiencies in the governance, firm management, risk management and internal control programs that contributed to, or were revealed by, the financial and banking crisis of 2008, including, in addition to liquidity risk management issues, the following:

- The failure of some boards of directors and senior managers to establish, measure and adhere to a level of risk acceptable to the firm;
- Compensation programs that conflicted with the control objectives of the firm;
- Inadequate and often fragmented technological infrastructures that hindered effective risk identification and measurement; and
- Institutional arrangements that conferred status and influence on risk takers at the expense of independent risk managers and control personnel.

The observations set forth in the report are intended to support the ongoing efforts of the various supervisory agencies to define policies that enhance financial institution resilience and promote global financial stability. Notably, representation of the United States in the SSG consists of the Board of Governors of the Federal Reserve System, the Federal Reserve Board of New York, the Office of the Comptroller of the Currency and the Securities and Exchange Commission.

## Implications of the SEC's New Disclosure Regime for Investment Company Directors

The legal duties of investment company directors have generally been defined by state law (depending upon the law of the state in which the investment company is formed), the Investment Company Act of 1940, as amended (1940 Act) and the rules thereunder, as well as certain common law doctrines (e.g. the duty of care and the duty of loyalty). In 2010, mutual funds became subject to new disclosure rules that are intended to enhance the information provided to shareholders and permit shareholders to evaluate the leadership of the funds. In particular, the new rule and form amendments require fund disclosure documents to describe the leadership structure of the Board of Directors and the role of the Board of Directors in risk oversight.<sup>19</sup>

While the oversight role of the Board of Directors in connection with risk management is not a new role, the new disclosure requirements may result in boardroom discussions of how a board may best discharge its duties for risk oversight. Fund boards customarily have audit, nominating and compensation committees. In view of the myriad risks attendant to financial innovation, fund boards may want to consider a board level risk committee if they have not already done so.

## The Importance of Scrutinizing Government Policy for Purposes of Systemic Risk Analysis

*The Financial Crisis Inquiry Report* also concludes that over-the-counter derivatives made a significant contribution to the global financial crisis of 2008.<sup>20</sup> The report points to legislation enacted in 2000 that banned the regulation of derivatives as a “key turning point” in the march toward the financial crisis. While the enactment of the Commodity Futures Modernization Act of 2000 (CFMA) is frequently cited as a significant factor that may have contributed to, or exacerbated, the crisis, commentators have generally ignored the legislative history of this unfortunate legislation.<sup>21</sup> The legislative history is noteworthy because it indicates that eight years before the crisis, the legislation effectively incorporated the deregulation

of credit default swaps into an omnibus budget bill without any meaningful discussion. Specifically, the legislative history indicates that a bill (H.R. 5660) was introduced in the House of Representatives on December 14, 2000, that a companion bill (S. 3283) was introduced in the Senate on December 15, 2000, just before the holiday recess, and that these bills were never debated in the House or the Senate. The legislation was signed into law by then President Clinton (in

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the final days of his administration) on December 21, 2000. These events are worthy of mention because they illustrate Congress' contribution to systemic risk and the costly consequences of a flawed legislative process.

The Dodd-Frank Act reverses the laissez-faire policy established by CFMA. It preserves the existing division of authority between the CFTC and the SEC, and divides jurisdiction between the two agencies. The CFTC's jurisdiction is based on a broad definition of “swaps” while the SEC's jurisdiction is limited to “security-based swaps.” Since the enactment of Dodd-Frank, the SEC has issued a number of rule proposals which, if adopted, will establish a new regulatory framework for security-based swaps. On April 7, 2011, the SEC and the CFTC delivered to Congress a Joint Study on the Feasibility of Mandating Algorithmic Descriptions for Derivatives.<sup>22</sup> Notably, the press release issued by the SEC on April 8, 2011, identifies the new Division of Risk, Strategy and Innovation as one of two divisions responsible for the SEC's participation in the study mandated by Section 719(b) of the Dodd-Frank Act.<sup>23</sup>

## Conclusion

In view of the numerous studies of, and commentaries on, the causes of the world financial crisis of 2008, it is likely that domestic regulators will continue to focus on systemic risk and the risk management practices of the investment

management industry. Innovation increases complexity. As financial innovation continues, industry participants must be vigilant, they must develop risk management programs that are de-

signed to specifically address the risks attendant to their operations and they must recognize the important role of governance in an effective risk management program.

#### ENDNOTES

- <sup>1</sup> Richard Bookstaber, *A Demon of Our Own Design: Markets, Hedge Funds and the Perils of Financial Innovation* (Hoboken: John Wiley & Sons, Inc. 2007).
- <sup>2</sup> *Id.*, p. 1.
- <sup>3</sup> In ancient Greek mythology, Icarus is the son of Daedalus, a master craftsman who constructed a pair of wings made of feathers and wax. In his efforts to escape Crete wearing the wings, Icarus is imbued with a sense of his own majesty and ignores his father's warnings that the wings will melt if he flies too close to the Sun. Icarus' catastrophic fall into the sea is often cited as an example of hubris and excessive risk taking.
- <sup>4</sup> See <http://www.sec.gov/news/press/2009/2009-199.htm>.
- <sup>5</sup> A public version of Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme is available at <http://www.sec.gov/news/studies/2009/oig-509.pdf>.
- <sup>6</sup> A public version of Review of the Commission's Processes for Selecting Investment Advisers and Investment Companies for Examination is available at <http://www.sec-oig.gov/Reports/AuditsInspections/2009/470.pdf>.
- <sup>7</sup> The Study is available at <http://www.sec.gov/news/studies/2011/914studyfinal.pdf>. The Study specifically states that it is a study by the staff of the Division of Investment Management and that the Commission has expressed no view regarding the analysis, findings or conclusions contained therein.
- <sup>8</sup> *Id.*, page 27.
- <sup>9</sup> See "Statement on Study Enhancing Investment Adviser Examinations (Required by Section 914 of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act) available at <http://www.sec.gov/news/speech/2011/spch011911ebw.pdf>.
- <sup>10</sup> *Id.*
- <sup>11</sup> See <http://www.sec.gov/news/speech/2011/spch032111cvd.htm>.
- <sup>12</sup> *Id.*
- <sup>13</sup> For a useful discussion of COSO ERM, see *COSO ERM: Understanding the New Integrated Framework* by Robert R. Moeller (Hoboken: John Wiley & Sons, Inc. 2007). See also *Enterprise Risk Management – Integrated Framework* available at [http://www.coso.org/documents/COSO\\_ERM\\_ExecutiveSummary.pdf](http://www.coso.org/documents/COSO_ERM_ExecutiveSummary.pdf).
- <sup>14</sup> *Icarus in the Boardroom: The Fundamental Flaws in Corporate America and Where They Came From* by David Skeel (New York: Oxford University Press 2005).
- <sup>15</sup> *Id.*, page 5.
- <sup>16</sup> *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (New York: Public AffairsTM, a Member of the Perseus Books Group 2011).
- <sup>17</sup> *Id.*, page xix.
- <sup>18</sup> The FSF was founded in 1999 by the G7 Finance Ministers and Central Bank Governors for the purpose of promoting stability in the international financial system through enhanced cooperation among various national and international supervisory bodies and international financial institutions. In November 2008, the Leaders of the G20 countries called for a larger membership of the FSF. A broad consensus emerged in the following months towards placing the FSF on stronger institutional ground with an expanded membership - to strengthen its effectiveness as a mechanism for national authorities, standard setting bodies and international financial institutions to address vulnerabilities and to develop and implement strong regulatory, supervisory and other policies in the interest of financial stability. As announced in the G20 Leaders Summit of April 2009, the expanded FSF was re-established as the Financial Stability Board (FSB) with a broadened mandate to promote financial stability.
- <sup>19</sup> See Rel. No. 33-9089, 34-61175, IC-29092, Proxy Disclosure Enhancements, available at <http://www.sec.gov/rules/final/2009/33-9089.pdf>.
- <sup>20</sup> *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (New York: Public AffairsTM, a Member of the Perseus Books Group 2011), p. xxiv.
- <sup>21</sup> See Public Law 106-554, §1(a)(5) which has been cited as a public policy decision that may have made significant contributions to both the Enron bankruptcy in 2001 and the liquidity crisis of 2007-2008.
- <sup>22</sup> See press release issued by the SEC on April 8, 2011, at <http://www.sec.gov/news/press/2011/2011-89.htm>.
- <sup>23</sup> *Id.*

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