The Inspector General's Statement on the SEC's Management and Performance Challenges

U.S. Securities and Exchange Commission

Office of Inspector General

Contents

Introduction

Every year, the U.S. Securities and Exchange Commission's (SEC or Agency) Office of Inspector General (OIG) provides an independent perspective on the Agency's top management and performance challenges. This report is based on our recent oversight activities, the SEC's progress in implementing our recommendations, and our outreach during the year to leadership and senior officials throughout the SEC. By examining the risks and challenges facing the SEC, our report supports fulfillment of the Agency's critical role in the American economy: protecting investors, maintaining fair, orderly, and efficient markets, and promoting capital formation.

The current budget environment constrains the SEC's ability to address each of the challenges described in this report. Flat funding for Fiscal Year (FY) 2024 required an Agency-wide freeze on hiring, as well as the elimination of certain performance bonuses and other employee benefits. Increasing personnel costs limit the resources available to update and improve legacy information systems, including information security. The changing regulatory environment will likely increase operational demands on the Agency and its staff. Lack of resources may hinder the Agency's ability to meet these challenges, mitigate its risks, and pursue its vital mission.

Finally, a word about the format of this year's report. The OIG has adopted a cycle of preparing a detailed narrative examination of the top management and performance challenges in some years, as we did in 2023, to be followed by shorter, summary reports, like this one, in the off-years.

We look forward to working constructively with the SEC to address these opportunities for improvement in the current environment. The management and performance challenges outlined in the report will guide the planning and performance of our oversight in FY 2025 and future years.

The OIG's website offers additional information about oversight of the SEC, including all reports mentioned here.

CHALLENGE 1

Meeting Regulatory and Oversight Responsibilities

2024 UPDATES

- ➤ Navigating a Changing Regulatory Landscape
- ➤ Overseeing Market Participants
- ➤ Protecting Investors from Crypto-Asset Related Fraud
- ➤ Jury Trial for Civil Penalties in Securities Fraud Cases

The SEC plays an integral role in the nation's economy, regulating and overseeing the more than $100 trillion U.S. capital markets, four times the assets of the U.S. banking system. More than half of American households own stocks or mutual funds, making robust markets and investor protection critical to the financial security of most Americans. It is therefore critical that the SEC performs well and operates with efficiency and integrity to meet its mission.

Navigating a Changing Regulatory Landscape

Under its current leadership, the SEC has maintained a substantial rulemaking agenda, tackling consequential issues. Since 2021, the Agency has proposed 55 rules and finalized 43 rules.

Challenges to SEC rules have become more frequent. For example:

- The Climate Disclosure Rule[1] was challenged in the Fifth, Second, Sixth, Eighth, Eleventh, and District of Columbia (DC) Circuits, in actions ultimately consolidated before the Eighth Circuit.[2] The SEC voluntarily stayed implementation of the rule, pending judicial review.
- The Private Fund Adviser Rule[3] was vacated by the Fifth Circuit on the grounds that the SEC exceeded its statutory authority in adopting the rule.[4]
- The Share Repurchase Rule[5] was also vacated by the Fifth Circuit, finding the SEC's adoption of the rule arbitrary and capricious due to an absence of reasoned decision making and failure to conduct a proper cost-benefit analysis.[6]
- A DC district court found that the SEC exceeded its authority in promulgating 2020 amendments[7] to proxy rules.[8]

> The SEC should anticipate increased litigation by parties challenging current and future rulemakings and ensure that new regulations will withstand judicial scrutiny.

SEC rulemaking will continue to face searching judicial scrutiny following the Supreme Court's 2023 term. The Supreme Court's decision in *Loper Bright Enterprises v. Raimondo*, 144 S. Ct. 2244 (2024) overturned forty years of precedent that required courts to defer to an administrative agency's reasonable interpretation of its authorizing statute, whenever the statute is ambiguous or silent on a particular issue. Following *Loper Bright*, a court must exercise independent judgment in deciding whether an agency has acted within its statutory authority and may not defer to the agency's interpretation of ambiguous provisions of its governing statutes.

The current regulatory environment may lead to increased forum shopping by petitioners and extended periods of uncertainty about the permissible scope of agency action.

With heightened judicial scrutiny, agencies, including the SEC, must continue to develop a thorough administrative record, including meaningful opportunity for public participation and reasoned responses to public submissions. The SEC already invests considerable resources toward these ends, but should be prepared for additional litigation, as industry and public interest groups may take opportunities to challenge regulations.

Given the SEC's active rulemaking agenda, the OIG is conducting an audit of the SEC's rulemaking processes and internal controls, focusing on:

- The opportunity for interested persons to participate in rulemaking;
- Assessing and documenting the impact of proposed rules on competition, efficiency and capital formation; and
- Ensuring that staff with appropriate skills and experience are involved in formulating and reviewing proposed rules.

We anticipate completing the report in FY 2025.

PRIOR OIG WORK

- *Use of the Current Guidance on Economic Analysis in SEC Rulemakings, Report No. 518 (June 6, 2013)*
- *Implementation of the Current Guidance on Economic Analysis in SEC Rulemakings, Report No. 516 (June 6, 2013)*
- *Follow-Up Review of Cost-Benefit Analyses in Selected SEC Dodd-Frank Act Rulemakings, Report No. 499 (January 27, 2012)*
- *Report of Review of Economic Analyses Performed by the Securities and Exchange Commission in Connection with Dodd-Frank Act Rulemakings (June 13, 2011)*

Overseeing Market Participants

The SEC oversees U.S. capital markets totaling more than $100 trillion and approximately 40,000 entities—13,000 registered funds, 15,400 investment advisers, 3,400 broker-dealers, 25 national securities exchanges, 108 alternative trading systems, 10 credit rating agencies, and six registered clearing agencies. Limited resources make it imperative that the Agency conduct effective risk-based oversight and leverage technology and analytics.

The Division of Examinations' (EXAMS) risk-based program is intended to focus on firms, market participants, and practices that pose the greatest potential risk of securities law violations that can harm investors and the markets. In 2016 and 2022, we reported on the role of risk in EXAMS oversight of registered investment advisers and investment companies.

In September, we issued a report on the use of risk-based strategies in the selection and scoping of broker-dealer examinations. We found that the program metrics and planning for those examinations are too focused on numerical targets. Multiple managers and staff expressed the view that the effort to meet numerical targets negatively impacted the quality and/or scope of broker-dealer examinations. As a result, EXAMS may be unintentionally promoting practices that do not align with its stated risk-based approach. Similarly, our auditors found that staff did not always consider available risk information and priority areas when selecting examination candidates and deciding on the scope of examinations. Management concurred with our six recommendations to strengthen EXAMS' broker-dealer examination program.

Effective risk-based monitoring strategies are essential to overseeing 40,000 entities in increasingly complex markets.

In FY 2025, we will:

- Complete an audit of the Division of Corporation Finance's Disclosure Review Program to determine whether the program concentrated its resources on critical disclosures by implementing a risk-based process for selecting and reviewing filers' periodic reports and transactional filings.
- Initiate a review of the Division of Investment Management's investment company filing review processes and efforts to ensure appropriate investor protections, particularly by considering risk and when reviewing new investment products.

PRIOR OIG WORK

- *Enhanced Planning, Performance Enhanced Planning, Performance Measurement and Evaluation, and Information Can Improve Oversight of Broker-Dealer Examinations, Report No. 583 (September 23, 2024)*
- *Registered Investment Adviser Examinations: EXAMS Has Made Progress To Assess Risk and Optimize Limited Resources, But Could Further Improve Controls Over Some Processes, Report No. 571 (January 25, 2022)*
- *Although Highly Valued by End Users, DERA Could Improve Its Analytics Support by Formally Measuring Impact, Where Possible, Report No. 553 (April 29, 2019)*
- *TCP Established Method To Effectively Oversee Entity Compliance With Regulation SCI But Could Improve Aspects of Program Management, Report No. 551 (September 24, 2018)*
- *Audit of the Office of Compliance Inspections and Examinations' Investment Adviser Examination Completion Process, Report No. 541 (July 21, 2017)*
- *Office of Compliance Inspections and Examinations' Management of Investment Adviser Examination Coverage Goals, Report No. 533 (March 10, 2016)*

Protecting Investors from Crypto-Asset Related Fraud

The Federal Bureau of Investigation (FBI) recently reported that, in 2023, Americans suffered losses of $3.96 billion from "cryptocurrency-related investment fraud schemes."[9] Individuals over the age of 60 reported the highest losses. Many of the victims are retail investors unfamiliar with the technology and its risks. According to the FBI, criminals exploit cryptocurrencies in investment fraud because cryptocurrency:

- May be distributed, decentralized and transferred without the participation of financial intermediaries with established anti-fraud and anti-money laundering controls;
- Move instantaneously in irrevocable transactions; and
- Are easily exchanged and moved overseas, making them difficult to track and recover.[10]

State regulators have likewise reported a significant increase in enforcement actions relating to digital assets, including crypto-assets and products.

The SEC has experienced the same upward trend. In FY 2024, the SEC's Office of Investor Education and Advocacy (OIEA) received 5,876 crypto-related complaints, more than double that of any other type of complaint received. In comparison, OIEA received 1,075 crypto-related complaints in FY 2020.

Additionally, 18 percent of the SEC's tips, complaints, and referrals in FY 2024 were crypto-related.

> Protecting Americans from crypto-asset investment fraud remains a challenge for the SEC.

The SEC continues to bring enforcement actions related to crypto-assets, and many of them are being vigorously contested. Given the substantial uptick in investor complaints of crypto asset-related fraud, the need for robust enforcement is likely to increase, increasing the demands on SEC resources.

On the regulatory front, the SEC in January approved 11 spot bitcoin exchange-traded products (ETPs).[11] Several months later, the SEC approved eight spot ether ETPs.[12] EXAMS designated crypto-assets as a priority risk area in FY 2025 for monitoring and examinations.

Jury Trial for Civil Penalties in Securities Fraud Cases

In *SEC v. Jarkesy*, 114 S.Ct. 2117 (2024), the Supreme Court held that the Seventh Amendment guarantees the right to a federal jury trial to a defendant from whom the SEC seeks civil monetary penalties for securities fraud. Accordingly, the SEC can no longer use administrative (in-house) proceedings in contested securities fraud actions for civil penalties.

The decision may have broader implications for the SEC's enforcement program, as open questions remain, such as the constitutionality of seeking civil penalties in other types of administrative proceedings. It is difficult to predict whether the availability of a federal jury trial will make defendants more likely or less likely to resolve claims in advance of litigation. The uncertainty surrounding the SEC's ability to adjudicate other enforcement actions administratively, as well as the additional resources required to bring actions in federal court, pose challenges for the SEC.

Challenge 1 Endnotes

1 *The Enhancement and Standardization of Climate-Related Disclosures for Investors,* 89 Fed. Reg. 21668 (March 28, 2024).

2 *Iowa v. SEC*, No. 24-1522 (8th Cir. 2024).

3 *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, 88 Fed. Reg. 63206 (Sept. 14, 2023).

4 *Nat'l Ass'n of Priv. Fund Managers v. SEC*, 103 F.4th 1097 (5th Cir. 2024).

5 *Share Repurchase Disclosure Modernization*, 88 Fed. Reg. 36002 (June 1, 2023).

6 *Chamber of Commerce v. SEC*, 85 F.4th 760 (5th Cir. 2023).

7 *Exemptions from the Proxy Rules for Proxy Voting Advice*, 85 Fed. Reg. 55082 (Sept. 3, 2020).

8 *Institutional S'holder Servs. Inc. v. SEC*, No. 19-cv-3275, 2024 WL 756783 (D.D.C. Feb. 23, 2024).

9 Federal Bureau of Investigation Internet Crime Complaint Center, 2023 Cryptocurrency Fraud Report, at 12, *https://www.ic3.gov/AnnualReport/Reports/2023_IC3CryptocurrencyReport.pdf*.

10 *Id.* at 11

11 Order Granting Accelerated Approval of Proposed Rule Changes, as Modified by Amendments Thereto, to List and Trade Shares of Ether-Based Exchange-Traded Products, Securities Exchange Act Release No. 34-100224 (May 23, 2024).

12 Order Granting Accelerated Approval of Proposed Rule Changes, as Modified by Amendments Thereto, to List and Trade Shares of Ether-Based Exchange-Traded Products, Securities Exchange Act Release No. 34-100224 (May 23, 2024).

CHALLENGE 2

Recruiting and Retaining a Skilled Workforce

2024 UPDATES

- ➤ Lower Attrition and Vacancy Rates
- ➤ Increasing Compensation Costs
- ➤ Reduced Benefits

Consistently recognized as one of the best places to work in the federal government, the SEC considers its workforce to be its most important asset. Increasing personnel costs, coupled with flat funding in FY 2024, required the Agency to implement austerity measures, including a freeze on filling vacant positions and substantial benefit cuts. Without a budget increase in FY 2025, the SEC may be forced to eliminate additional benefits. The long-term effects on the workforce and on the Agency's operations are unlikely to be positive.

Lower Attrition and Vacancy Rates

In last year's report, we noted concerns about the Agency's rising vacancy rate and staff attrition, and the resulting pressure on operations. The intervening year has seen some progress, in that only 8 percent of the authorized positions are vacant, down from 9.3 percent in FY 2023, while attrition declined from 4.7 percent to 3.4 percent. After a push to fill vacant

positions in late FY 2023, the SEC froze most hiring for FY 2024, due to uncertainty about funding levels, and that freeze remains in effect.

Increasing Compensation Costs

The SEC now faces the challenge of compensating its employees within available funding levels. Staffing levels have remained relatively steady, with only a 5 percent increase from 2016 until the present. Personnel costs, however, consume an increasing share of the SEC's budget, rising from 64 percent in FY 2023 to 70 percent in FY 2024. This stems, in large part, from government-wide salary increases, merit pay raises for SEC staff rated "Accomplished Performers," and increasing health insurance and other federal benefits costs. To offset its increased payroll costs, the SEC suspended FY 2024 contributions towards employees' supplemental retirement benefits and assistance through the student loan repayment program. With FY 2025 funding uncertain, the Agency may need to suspend these and other benefits, with final decisions to be made after passage of appropriations laws.

Reduced Benefits

The suspension of these benefits for FY 2024 and contemplated benefit cuts in FY 2025 could negatively impact the Agency's ability to recruit and retain highly skilled staff.

The SEC employs highly skilled professionals, with specialties sought after in the private sector and by financial regulators. Reduced benefits, and ongoing uncertainty about future reductions, may negatively impact workforce retention and, in the future, recruiting and hiring.

In FY 2024, we initiated an audit to:

- Determine the extent to which the SEC has implemented leading human capital management practices and government-wide guidance related to recruitment and retention; and
- Evaluate the mechanisms used by the SEC to assess the effectiveness of its recruitment and retention efforts for FY 2022 and 2023.

The audit will be completed in FY 2025, and its results should assist the SEC when it resumes hiring.

PRIOR OIG WORK

- *Final Management Letter: Review of Upward Mobility Program (May 1, 2023)*
- *The SEC Can Improve in Several Areas Related to Hiring, Report No. 572 (February 28, 2022)*
- *Review for Racial and Ethnic Disparities in the SEC's Issuance of Corrective and Disciplinary Actions from January 1, 2017–August 31, 2020 (August 26, 2021)*
- *The SEC Made Progress But Work Remains To Address Human Capital Management Challenges and Align With the Human Capital Framework, Report No. 549 (September 11, 2018)*
- *Final Closeout Memorandum: Audit of the SEC's Hiring Practices (August 19, 2016)*
- *Audit of the Representation of Minorities and Women in the SEC's Workforce, Report No. 528 (November 20, 2014)*

CHALLENGE 3

Protecting Systems and Data

2024 UPDATES

- ➤ X (Twitter) Account Compromise
- ➤ Consolidated Audit Trail
- ➤ Annual Evaluation of Information Security

Robust information security protects systems and data from compromise by malicious actors. The SEC must maintain the confidentiality, integrity, and availability of sensitive data and must respond effectively to breaches and security incidents. We note that the Office of Information Technology (OIT) staff and contractors have sometimes taken actions without anticipating their downstream effects.

X (Twitter) Account Compromise

On January 9, 2024, an unauthorized party gained control of the SEC's account on the X (formerly Twitter) platform and posted falsely that the SEC had approved "#Bitcoin ETFs for listing on all registered national securities exchanges." The bogus announcement led to a brief $1,000.00 (2.5 percent) spike in the price of bitcoin.

The Agency had not approved spot bitcoin exchange-traded funds (ETFs) at the time of the posting. The SEC quickly issued a statement that the posting was false and that no decision had been reached regarding spot bitcoin ETFs. (The following day, the SEC approved spot bitcoin exchange-traded products.)

As reported by X's security operations, the SEC had not protected its X account with two-factor authentication, enabling the hacker to gain access to the account via a SIM swap.

Following a joint OIG-FBI investigation, an Alabama man was arrested on October 17, 2024 in connection with the hack. The indictment charged that he conspired with others to commit aggravated identity theft and fraud by stealing the identity of a person who had access to the X account and taking over the account through the unauthorized SIM swap.[13] The investigation is continuing.

> We initiated an audit of the SEC's controls for safeguarding CAT data available to SEC users and responding to CAT security events within the SEC's environment.

Consolidated Audit Trail

On May 6, 2010, the stock market and other securities exchanges experienced a "flash crash," a sudden, huge intraday trading loss. It took regulators many months to reconstruct the market events that led to the crash and take appropriate action. The SEC thereafter adopted Rule 613 to create a comprehensive Consolidated Audit Trail (CAT) that would allow regulators to efficiently and accurately track all activity throughout the U.S. markets in National Market System securities. The CAT is intended to allow regulators to more efficiently and effectively conduct research, reconstruct market events, monitor market behavior, and identify and investigate misconduct.

Some have voiced concerns with the ability of this system to maintain investor privacy and secure personal data, rising costs and the fairness of the funding plan. We initiated an audit of the SEC's controls for safeguarding CAT data available to SEC users and responding to CAT security events within the SEC's environment. The audit is expected to be completed in the upcoming months.

Annual Evaluation of the SEC's Information Security

By statute, the OIG evaluates annually the SEC's implementation of the Federal Information Security Modernization Act of 2014 (FISMA). The SEC has made progress in improving its information security program. However, as we reported, remaining challenges prevent its program being rated "effective." These challenges have broadly included developing plans to effectively mitigate security weaknesses, designing and implementing new baseline controls, and meeting government-wide logging requirements. We will continue to track the SEC's progress to address open and outstanding recommendations from our FY 2022 and 2023 FISMA evaluations as we complete this year's evaluation in the coming months.

SEC's Assessed Maturity Level for FY 2023	
Security Function	**FY 2023 Assessed Maturity Level**
Identify	Level 3: *Consistently Implemented*
Protect	Level 2: *Defined*
Detect	Level 2: *Defined*
Respond	Level 4: *Managed and Measurable*
Recover	Level 2: *Defined*
Overall Maturity	Level 3: *Consistently Implemented*

Source: Fiscal Year 2023 Independent Evaluation of the U.S. Securities and Exchange Commission's Implementation of the Federal Information Security Modernization Act of 2014; Report No. 580 (December 20, 2023).

PRIOR OIG WORK

- *Fiscal Year 2023 Independent Evaluation of the U.S. Securities and Exchange Commission's Implementation of the Federal Information Security Modernization Act of 2014, Report No. 580 (December 20, 2023)*
- *Final Management Letter: Readiness Review—The SEC's Progress Toward Implementing Zero Trust Cybersecurity Principles (September 27, 2023)*
- *Final Management Letter: Review of SEC Controls Over Public Comments Submitted Online and Actions Taken in Response to a Known Error (April 14, 2023)*
- *Fiscal Year 2022 Independent Evaluation of the SEC's Implementation of the Federal Information Security Modernization Act of 2014, Report No. 574 (November 15, 2022)*
- *Fiscal Year 2021 Independent Evaluation of the SEC's Implementation of the Federal Information Security Modernization Act of 2014, Report No. 570 (December 21, 2021)*
- *Additional Steps Are Needed For the SEC To Implement a Well-Defined Enterprise Architecture, Report No. 568 (September 29, 2021)*
- *Final Management Letter: Review of the SEC's Compliance With CISA Emergency Directive 21-01 and Initial Response to the SolarWinds Compromise (August 3, 2021)*
- *Fiscal Year 2020 Independent Evaluation of SEC's Implementation of the Federal Information Security Modernization Act of 2014, Report No. 563 (December 21, 2020)*

Challenge 3 Endnotes

13 *See https://www.justice.gov/opa/pr/alabama-man-arrested-role-securities-and-exchange-commission-x-account-hack*.

CHALLENGE 4

Contract Management

2024 UPDATES

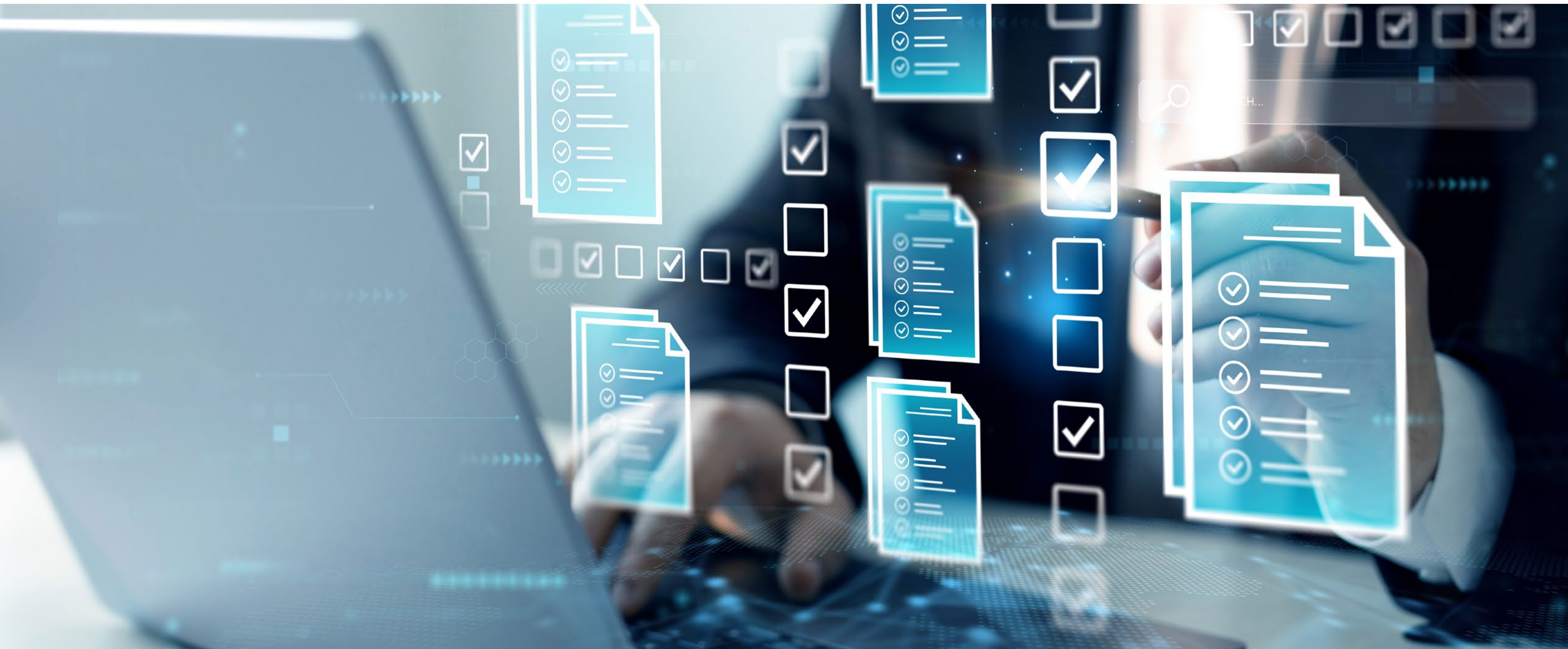
➤ Time-and-Materials Contracts

Contract management is a challenge across the federal government, and the SEC is no exception. The majority of the SEC's contract dollars are dedicated to IT services, including application management and development, infrastructure and operations management, and information security.

By FY 2021, over half of the SEC's contract dollars were for time-and-materials (T&M) contracts. As recognized in the Federal Acquisition Regulation, T&M contracts do not reward a contractor for cost control or labor efficiency, are generally considered riskier, and may only be used in certain circumstances. The SEC obligated more than $375 million to T&M contracts at the end of FY 2023. The OIG therefore conducted an audit to assess the strength of the SEC's controls for the use and management of T&M contracts.

Contracting officers reported that the SEC divisions and offices that most frequently procure goods and services prefer T&M contracts and pressure the contracting officers to award them. Some attributed this to agency culture and because firm fixed-price contracts require more work up front to detail the work to be performed.

Further, we found that the Agency did not have in place policies and procedures for converting T&M contracts to other pricing structures, as suggested in a prior OIG report.



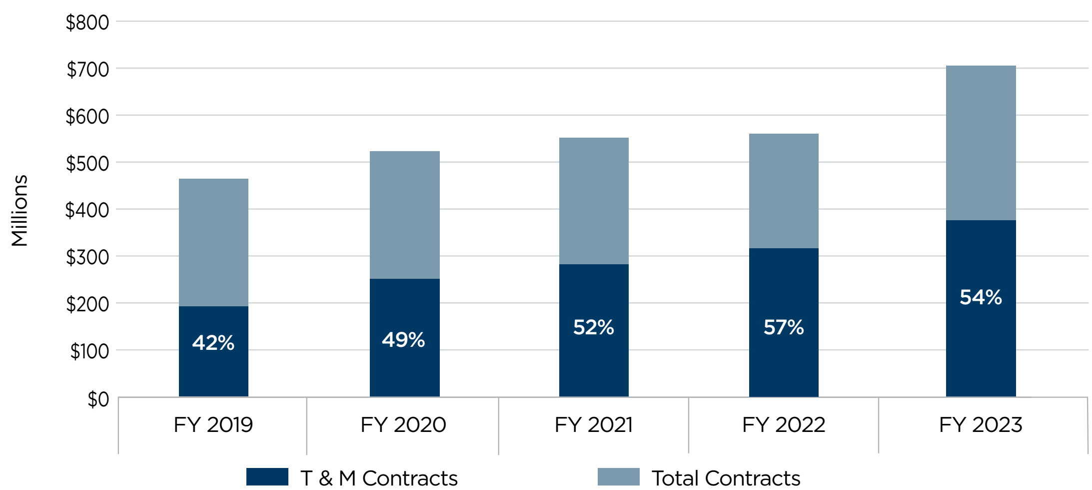
To limit risk, federal regulations instruct contracting officers to avoid protracted use of T&M contracts when experience provides a basis for firmer pricing.

And, although T&M contracts require close surveillance and management to prevent the government from being overcharged, we reported that half of the surveillance plans in our sample were inadequate. Consequently, the SEC overlooked opportunities to convert certain T&M contracts to a lower-risk contract type, and thereby reduce risk and save the substantial resources needed for effective contract surveillance.

Finally, we found that third-party (i.e., contracted) contract file reviews were deficient. Between August 2020 and August 2022, the SEC paid an estimated $430,000–$520,000 for file reviews that were not always effective. The SEC has since awarded a new contract for this work and, to date, has not identified similar performance issues. We made two recommendations to improve third-party contract file reviews.

The SEC agreed with our seven recommendations to help lower the SEC's contract risk and improve its management of T&M contracts.

SEC T&M Contract Obligations vs. Total Contract Obligations (FY 2019–FY 2023)



Source: The SEC Missed Opportunities to Lower Contract Risk and More Effectively Manage Time-and-Materials Contracts, Report No. 582 (August 26, 2024).

PRIOR OIG WORK

- *The SEC Missed Opportunities to Lower Contract Risk and More Effectively Manage Time-and-Materials Contracts, Report No. 582 (August 26, 2024)*
- *The SEC Supported Federal Small Business Contracting Objectives, Yet Could Make Better Use of Data and Take Other Actions to Further Promote Small Business Contracting, Report No. 577 (February 28, 2023)*
- *The SEC Has Taken Steps to Strengthen its Monitoring of ISS Contractor's Performance, But Additional Actions are Needed, Report No. 565 (February 24, 2021)*
- *The SEC Can Better Manage Administrative Aspects of the ISS Contract, Report No. 554 (May 31, 2019)*

OIG Contact Information

Employee Suggestion Program

The OIG SEC Employee Suggestion Program, established under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, welcomes suggestions by all SEC employees for improvements in the SEC's work efficiency, effectiveness, productivity, and use of resources. The OIG evaluates all suggestions received and forwards them to agency management for implementation, as appropriate. SEC employees may submit suggestions by calling the OIG Hotline at (833) SEC-OIG1 (732-6441) or by filling out the OIG online complaint form.

Comments and Ideas

The SEC OIG also seeks ideas for possible future audits, evaluations, or reviews. We will focus on high-risk programs, operations, and areas where substantial economies and efficiencies can be achieved. Please send your input to AUDPlanning@sec.gov.

To Report

FRAUD, **WASTE**, and **ABUSE** involving SEC programs, operations, employees, or contractors

FILE A COMPLAINT ONLINE AT
WWW.SEC.GOV/OIG

CALL THE 24/7 TOLL-FREE OIG HOTLINE
833-SEC-OIG1

U.S. Securities and Exchange Commission
Office of Inspector General
100 F Street, N.E.
Washington, DC 20549
WWW.SEC.GOV/OIG