

# Office of Economic Analysis

## Overview

*“The growth and automation of the financial markets makes it imperative that the Commission use quantitative methods to increase the productivity of the Commission’s surveillance and rulemaking programs. The staff of the Office of Economic Analysis apply the latest econometric methods to help identify issues that otherwise might go unnoticed.”*

Larry Harris  
SEC Chief Economist

20 staff in the Office of Economic Analysis:

- Provided the technical and analytical support necessary to understand and evaluate the economic effects of Commission regulatory policy, including the costs and benefits of rulemaking initiatives.
- Reviewed all rule proposals to assess their potential effects on small businesses; competition within the securities industry and across competing securities markets; efficiency and capital formation; and costs, prices, investment, innovation and the economy.

## Key Results

Issue	Result
Implications of the Growth of Hedge Funds	We collected and analyzed hedge fund data in support of the Commission-issued staff report of hedge funds. In particular, we examined hedge fund operations, their service providers, and their interactions with investors and the markets.

Issue	Result
Sarbanes-Oxley Act Study	We produced a study on the “Adoption by the U.S. Financial Reporting System of a Principles-Based Accounting System” in collaboration with the Office of the Chief Accountant.
Market Structure Issues	We assisted the Division of Market Regulation on a variety of market structure issues, including trade-throughs, access fees, exchange registration, market data, the impact of locked and crossed markets, short selling, and position limits for narrow-based futures contracts.
Analytical Tools	We developed analytical tools that allow Commission staff to identify trends in certain filings and extract information from documents posted to the Internet.
Evaluation of Breakpoint Compliance by Funds and Broker-dealers	We analyzed the potential magnitude of the harm to investors by the misappropriation of mutual fund breakpoint discounts and assisted in the design of the NASD breakpoint-related survey.

Main Activities	Fiscal 2003	Fiscal 2002	% Change
Reviews of Commission and SRO Rules	124	118	+5%
Regulatory Flexibility Analyses	81	67	+21%
Memoranda and Reports	159	143	+11%
Advice on Regulatory and Enforcement Issues	596	480	+24%

## Economic Analysis and Technical Assistance

### Implications of the Growth of Hedge Funds

At the direction of the Commission, the Division of Investment Management (IM), Office of Compliance Inspections and Examinations (OCIE), and Office of Economic Analysis undertook a fact-finding mission aimed at reviewing the operations and practices of hedge funds. Our role in this study involved

providing analytical support and guidance to OCIE and IM and collecting and processing data from a survey of industry participants conducted by OCIE. In addition, we acquired commercial data on the hedge fund industry from numerous providers and performed detailed quantitative analyses.

### Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act mandated that the Commission conduct a study of the adoption by the United States financial reporting system of a principles-based accounting system. Congress recognized that questions remained regarding the approach by which accounting standards are established. As directed by the Act, we conducted a study of the approach to standard-setting in the U.S. We found that standards established on either a rules-based or a principles-only basis are likely to lead to lower quality financial reports. More specifically, we found that, on the one hand, principles-only standards

may present enforcement difficulties because they provide insufficient guidance or structure for exercising professional judgment by preparers and auditors. On the other hand, we found that rules-based standards often provide a vehicle for circumventing the intention of the standard. The study concluded that principles-based standards strike an appropriate balance between these extremes. As a result of our study, the staff recommended that those involved in the standard-setting process more consistently develop standards employing a principles-based approach.

### Market Structure Issues

The economic analysis staff provided economic advice and guidance on a variety of market structure issues, including trade-throughs, access fees, exchange registration, market data, the impact of locked and crossed markets, short selling, and position limits for narrow-based futures contracts. We provided economic analysis and advice on the market efficiency and

limit order protection impacts of permitting trades to execute up to three cents outside the quote in certain exchange traded funds, pursuant to a temporary exemption. The staff assisted the Commission with its review of significant structural issues in the equity and options markets, including those related to access fees, distribution of market data revenues, short sale regulation,

and trading increments. We also provided support and analysis regarding issuer share repurchases, the Nationally

Recognized Statistical Ratings Organizations concept release, and the TRACE bond transaction reporting system.

### Analytical Tools for Better Decision-making

During the year, we developed tools to be used by Commission staff as part of regular review of issuer filings. First, we developed a web-crawling software tool that allows staff members throughout the SEC to automatically collect data from any web-based source, including EDGAR. This tool helps staff to examine EDGAR

filings in real-time as they arrive. Second, we developed tools that allow for the electronic comparison of certain portions of issuer filings, such as the Management Discussion and Analysis filed as part of Form 10-K. This tool should assist the staff in classifying the quality of mandated disclosure of risks.

### Evaluation of Breakpoint Compliance by Funds and Broker-dealers

The economic analysis staff provided economic advice and guidance to IM and OCIE in evaluating breakpoint compliance by mutual funds and broker-dealers. We analyzed the potential magnitude of harm to investors by the misappropriation of mutual fund breakpoint discounts and assisted in

the design of the National Association of Securities Dealers' (NASD) survey. The NASD directed securities firms to conduct an assessment of their mutual fund transactions, using a statistically significant sample of the 2001 and 2002 transactions, from which overall performance was determined.

### Outlook for 2004

Our main objectives are to:

- Publish studies mandated by Congress, such as the Sarbanes-Oxley Act study of special purpose entities and a study of the impact of Section 31 fees on market participants and investors.
- Continue to advise the Commission and assist the staff by providing analysis in the areas of equity, debt and derivative securities market structure, disclosure, corporate governance, market

intermediaries, and investment management.

- Continue to work on applications that might aid our review processes, such as insuring that registrants are filing certifications required by the Sarbanes-Oxley Act of 2002. We expect that these techniques will allow the SEC to quickly obtain data from EDGAR that would not otherwise be easily available to us until the EDGAR filings are fully tagged.