

RESPONSE TO QUESTION OF SENATOR PROXMIRE

Hearing of April 17, 1985

Question 1. [W]hat I would like for the record is the number of times in the last three years that you [the Commission] have decided against bringing an action where the Division of Enforcement thought one should be brought.

Answer. In response to your inquiry, the Commission's Office of the Secretary has reviewed the minute records for the relevant periods. Those records are indexed by name and not by action taken or not taken by the Commission or individual Commissioners. While we cannot be absolutely certain that no Commission actions were overlooked, we believe this response to be an accurate statement of Commission actions taken during the period from October 1, 1982 through May 14, 1985.

The following chart indicates by year and type of action the number of times the Commission has disapproved recommendations of the Division of Enforcement.

	<u>CHART A</u>			
	<u>FY '82</u>	<u>FY '83</u>	<u>FY '84</u>	<u>FY '85 (through 5/14/85)</u>
Institution of Injunctive Action	2	2	0	0
Institution of Administrative Proceeding of an Enforcement Nature	2	1	1	1
Other */	0	0	1	0

*/ Reports pursuant to Section 21(a) of the Securities Exchange Act of 1934 ("Exchange Act").

For purposes of comparison, the following chart indicates the total number of enforcement actions instituted during the relevant period.

CHART B

	<u>FY '82</u>	<u>FY '83</u>	<u>FY '84</u>	<u>FY '85 (through 2nd Quarter)</u>
Injunctive Actions	136	151	179	52
Administrative Proceedings of an Enforcement Nature (Including Rule 2(e) Proceedings)	106	94	114	59
Section 21(a) Reports	3	2	2	0

In addition, the Commission disapproved recommendations to enter a formal order of investigation: FY '82 - 0; FY '83 - 1; FY '84 - 1; FY '85 - 4. The number of formal orders approved in those years were: FY '82 - 137; FY '83 - 152; FY '84 - 113; and FY '85 - 76. (Three of the four disapproved recommendations for FY '85 were referred to state securities commissions, and the remaining recommendation was deferred, pending confirmation by the staff of additional facts justifying the need for the formal order.)

There were also cases in which the Commission modified the recommendation of the Division of Enforcement. The Commission modified recommendations by deleting proposed violations or defendants in six matters in FY '82; ten matters in FY '83; nine matters in FY '84; and seven matters in FY '85 (through May 14, 1985).

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Question 2. Have your economists done any studies of the costs imposed on business of fending off and defending against hostile takeovers, like attorney's fees, investment bankers' fees and so forth?

Answer. The costs and benefits associated with tender offers have been examined seriously and intensively by the economists at the SEC. It should be pointed out that the costs to which you refer -- attorney's fees and the like -- are a small fraction of the overall magnitude of the net benefits associated with successful tender offers, or the net cost of failed ones.

Senator Cranston has submitted a written question which is virtually identical to yours, as well as a closely related second question. In view of this similarity, we are enclosing a copy of our reply to Senator Cranston along with some accompanying documents, including some of our published studies of this issue. We apologize for giving you the erroneous impression at the hearing that we have not examined this issue.

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Question 1. Authorization.

Part a. A number of statements in the budget submissions seem to be at odds with the budget request. For example, with respect to the Supervision and Regulation of Securities Markets, you state that

"The expanded volume and complexity of the securities trading markets have increased program workload. All market activity indicators are up sharply for the past five years: stock exchange share volume has increased by 228 percent, over-the-counter share volume has risen 450 percent, and exchange option contract volume has grown 224 percent. Complicating this growth are new entrants to the securities services industry, new securities products and the growth of the regulated professional population."

Yet you have reduced the number of staff positions in the Division of Market Regulation from 135 in 1984 to 120 in 1985 and you are content with 120 positions in 1986. Then with respect to the Division of Enforcement, I read that

"The rapid growth of the securities industry has been accompanied by increases in the indices of potential fraud. However, as complex financial instruments proliferate and markets cross national boundaries, the pursuit and deterrence of fraud becomes increasingly difficult. Consequently, the program must have adequate resources to effectively carry out its responsibilities in a highly technical area of the law."

Yet the resources and staff positions in 1986 for the Division of Enforcement remain the same as in 1985. You are content with what you've got.

And with respect to the Division of Corporation Finance you state that "The projected market growth will trigger increased workload in all areas of the program." But once again, no recommended increases.

How can you make these statements on the one hand and come in to us with a bottom line -- which is essentially a budget freeze -- on the other?

Answer. While the securities industry is increasing in size and complexity, the resource levels contained in the President's budget are both realistic and sufficient for the SEC to discharge its statutory mandate. In 1984, as compared with 1981, the Commission achieved record results in all major program areas with 5% fewer staff. This was achieved through paperwork reduction, automation and other initiatives which enhanced staff productivity. The proposed 1986 budget contains 25 more positions and a \$13 million increase in appropriations over 1984 levels. While it may not be possible to continue achieving record results in the coming years, the Commission is confident that, with the resources proposed, it can fully and effectively discharge its mandate in 1986.

Part b. Commissioner Aulana Peters is reported in the February 11, 1985 edition of Wall Street Letter as having "decried the over-all budget freeze, saying it will 'affect our effectiveness

to regulate'". I am wondering how you, the Chairman, believe it will affect the Commission's ability to regulate?

Answer. The President's 1986 budget does not propose a freeze for the agency, but rather provides an increase of \$885,000. It is true, however, that staff levels will not increase over the 1985-1986 period. Of course, the Commission could do more with more resources. Nevertheless, the staffing proposed for 1986 will permit the Commission to adequately regulate the securities markets and maintain a sound enforcement program.

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Question 2. Enforcement.

Part a. Do you believe that the Commission should be granted the authority to fashion monetary relief and impose fines for certain violations?

Answer. For many years the Commission has sought and obtained monetary relief in court actions, in the form of a disgorgement of ill-gotten gains. Also, the Insider Trading Sanctions Act of 1984 (Pub. L. 98-376, Aug. 10, 1984) ("ITSA"), gives the Commission authority to seek court-ordered civil penalties of up to three times the profit gained or loss avoided in unlawful insider trading transactions.

In 1984, the Commission considered the efficacy of its enforcement remedies, including the question of whether it should seek additional administrative authority to impose monetary penalties. Following that consideration, on February 28, 1984, we sent Chairman D'Amato a letter and an accompanying memorandum which concluded that such additional authority should not be sought at that time. However, the letter included several other

enforcement-related legislative proposals. These were:

- amendments to Section 15(c)(4) of the Securities Exchange Act expanding the Commission's authority (a) to compel compliance with certain additional disclosure and other requirements of that Act and (b) to institute administrative proceedings against individuals who are a cause of the failure to comply, by others, with any of the provisions enumerated in this section. These amendments were subsequently adopted as part of ITSA;
- amendments to Section 17A of the Act to allow the Commission to impose administrative sanctions on persons associated with transfer agents; and
- amendments to Section 24 of the Act to protect records submitted to the Commission in investigations and information submitted to it subject to attorney-client or other evidentiary privilege.

Copies of the February 28, 1984, letter and memorandum are attached.

The memorandum addresses civil money penalties at pages 6 through 8 and concludes:

- (1) Other than insider trading, the staff could not identify a serious need for additional remedies to deter specific conduct;

- (2) Additional civil penalties might change the character of the Commission's enforcement program. The federal securities laws are presently viewed by the courts as remedial rather than punitive. If amendments authorizing the imposition of civil money penalties were viewed as an expression of Congress' intent to change the character of the enforcement program from remedial to punitive, it might lead the judiciary to be less receptive to Commission injunctive actions. Additional consequences could include judicial determinations that the Commission must prove its cases by clear and convincing evidence, rather than by a preponderance of the evidence, and that enforcement actions must be litigated before a jury. Such developments would complicate enforcement proceedings and lead to the expenditure of additional resources in particular cases;
- (3) Money penalties could further complicate settlement of enforcement proceedings, resulting in the need to litigate a larger number of such proceedings, thereby reducing the number of such proceedings the Commission could undertake;
- (4) A final assessment of the net advantage or disadvantage of money penalties should await actual experience with them under the ITSA, which had not yet become law.

The ITSA has been in force for less than a year, and at present only two cases brought under its provisions have been concluded. We will continue to consider the question of whether to seek authority to impose additional monetary penalties as the Commission gains further experience under the ITSA.

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Part b. Should repeat offenders be barred from acting as corporate officers or directors?

Answer. In appropriate cases involving individuals who have engaged in egregious violations or demonstrated a pronounced and repeated tendency to ignore the law, the Commission has obtained this type of ancillary relief in the settlement of injunctive actions under the federal securities laws. Judicial orders barring individuals from corporate offices have been obtained in at least 20 cases since 1975.

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Part c. Is the Commission's general counsel currently drafting legislation that would ask Congress for extended powers?

Answer. The Commission currently has several legislative proposals before Congress, including the transfer agent enforcement proposals referred to above, introduced as part of H.R. 1604. The Office of the General Counsel is not currently drafting further proposals for an extension of the Commission's powers.

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Part d. "In the section in the budget submission on the 'Prevention and Suppression of Fraud' the SEC indicates that an area of special attention for the Commission will include 'problems arising from growth in the number of small regional broker-dealer firms.'

"What particular problems are you referring to in this area?"

Answer. Several of the Commission's regional offices have reported a substantial growth in the number of small broker-dealer registrants. For example, the number of broker-dealers registered in the Commission's Denver Region more than doubled in the two-year period 1982-84. The Commission's experience is that small newly-registered regional broker-dealers are often under-financed and staffed by under-trained and inadequately supervised personnel.

The combination of substantial growth in the number of small broker-dealer registrants and the problems associated with those registrants creates an environment that requires increased enforcement attention by the Commission and the self-regulatory organizations. Evidence of these requirements was supplied during the fiscal year by: (i) a number of small regional broker-

dealers that ceased doing business as a result, primarily, of net capital problems; and (ii) a noted increase in the number of cases involving questionable sales practices by these firms, including "churning" of securities accounts and unauthorized trading.

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Part e. "Other areas of special attention you state will include:

'(1) efforts by issuers, including publicly-owned banks and bank holding companies, to conceal adverse developments and financial information that is material to investors, (2) violations arising from increased trading of securities in the U.S. through foreign financial institutions, (3) abuses in connection with offerings of securities in oil and gas ventures, (4) problems associated with the market for small issues in the Denver area.'

"Would you describe your concerns in each of these areas a bit more fully for us?"

Answer.

Concealment of adverse developments and material financial information

During the fiscal year, matters observed by the Commission's enforcement staff raised renewed concerns in this area. A number of these matters dealt with troubled, failing or failed publicly traded banks, savings and loans and commercial or industrial finance companies. The Commission continues to note cases where the results of the adverse economic climate that prevailed several years ago were deliberately obscured by issuers in their financial statements.

The Commission recently brought a case that exemplifies certain of its concerns in this area -- In the Matter of Broadview Financial Corporation, Securities Exchange Act of 1934 Release No. 21949, April 17, 1985. A copy of the Commission's "Order Instituting Proceedings Pursuant to Section 15(c)(4) of the Securities Exchange Act of 1934 and Conclusion, Findings and Order of the Commission" in this case is attached as Exhibit A.

Domestic securities trading through foreign financial institutions

Foreign investment in U.S. securities has dramatically increased during the last decade. For example, in 1983 foreign investment in U.S. equities stood at \$5.4 billion, 39% greater than the prior year. Gross activity, purchases plus sales, grew 68% to \$134.3 billion from \$79.9 billion during the same period. Foreign investors accounted for approximately 10.5% of the value of the shares publicly traded on the New York Stock Exchange in 1983.

Based upon the above data, it is indisputable that foreign participation in the U.S. securities market is on the increase. The number of investigations where it is necessary to seek testimony or documents located abroad has, not unexpectedly, increased in proportion to this activity. In this regard, the Commission has initiated two of the largest insider trading cases ever brought which involve trading through Swiss bank accounts, SEC v. Tome (the "St. Joe" case), and SEC v. Certain Unknown Purchasers, et al. (the "Santa Fe" case).

It should also be noted that several foreign jurisdictions have, as a matter of law, prohibited banks and broker-dealers from disclosing information regarding banking and securities transactions to the U.S. While the Commission has been successful in obtaining evidence from these jurisdictions, such assistance has been available in only the most extraordinary cases. As a result, as access to the U.S. market from abroad is enhanced, investors attempting to reduce the chances of having their identities become known during a Commission investigation have begun to invest from these jurisdictions.

Oil and gas securities offerings

Several of the Commission's regional offices noted a proliferation of unregistered offerings in the oil and gas area during the fiscal year. This is a matter of special concern to the Commission's enforcement efforts because of the abuses that historically have occurred in connection with these offerings. A recent typical case that provides examples of these abuses is SEC v. First Oil and Gas Company, Civil Action No. 85-1370-H (C.D. Cal.).

The Commission's complaint also alleged that the defendants raised approximately \$2.5 million from at least 400 investors throughout the United States in violation of the securities and broker-dealer registration and anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934.

Denver small issue market

Historically, the Denver Regional over-the-counter market has been characterized by the large number of small regulated entities, including broker-dealers and transfer agents, which are under-financed and staffed by under-trained and poorly supervised personnel. Many of these firms specialize in the marketing and transferring of so-called "penny stocks" and securities of small start-up companies with little or no business or earnings history. In this environment, the opportunity for abuses is substantial and the need for a Commission enforcement presence concomitantly high.

The Commission's concerns in this area are closely connected with the substantial growth in small, newly-registered regional broker-dealers. See response to Part d. above.

In recent fiscal periods, the need to devote increased enforcement resources to the problems arising from the Denver Region "Hot Issue" market has been reduced due to the lower level of activity of that market. The Denver Regional over-the-counter market now appears, however, to be positioning itself for a possible resurgence of activity. This appearance is supported both by the number of newly-registered broker-dealers in the region and the number of registrations of securities filed in the region.

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Question 3. Market Regulation/Executive Staff.

I see that this year 1985 estimates for staff positions in the Regulation of Securities Markets will decrease by 15 staff positions from 268 in 1984 to 253 in 1985 while the Executive Staff will increase from 38 to 42 and the Executive Director's staff will increase from 16 to 19.

Why the cut in Market Regulation and the increase in the Executive Staff?

Answer. The Market Regulation staff was reduced by fifteen positions in order to provide the additional positions required by the Division of Corporation Finance to increase the level of review of annual reports (Forms 10-K) filed with the Commission. This reprogramming reflected clear Commission priorities and received the support of all Commissioners. As indicated in their individual testimony before the Subcommittee on Telecommunications, Consumer Protection, and Finance of the House Committee on Energy and Commerce, the Commissioners believe that the reprogramming left the market regulation program sufficiently staffed.

The Executive Staff was increased by four positions, from 38 in 1984 to 42 in 1985, in order to create an Office of Internal

Audit. The creation of this office within the Executive Staff was specifically mandated by the Congress in its 1985 appropriation for the Commission.

The Executive Director's staff has increased from 16 positions in 1984 to 19 positions in 1985. The increment reflects the transfer of the Equal Employment Opportunity Office to the staff of the Executive Director.

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Question 4. Corporate Finance.

Part a. I have been told that 60 percent of the Division of Corporation Finance has been with the Commission less than one year and that there is no formal or informal training program for new staff.

* How do you account for the high turnover in corporation finance and how do you respond to criticism that new entrants are inadequately trained for their responsibilities?

Answer. While the Division does have a number of employees that have less than one year, the reference to 60 percent is too high. Including current vacancies, the figure is 34.1%. The Division's turnover rate, has declined over the past four years from over 46% in FY 1981 to its present rate of 21% for the first half of fiscal year 1985. We believe the turnover is due primarily to high salary incentives in the private sector. In seeking candidates to fill vacancies the Division applies criteria that emphasizes background skills and knowledge necessary for its work. While some attorneys are hired directly out of school many are not. In addition, we continually seek experienced accountants and financial analysts.

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Part b.

- * Wouldn't the Commission be well advised to establish some kind of minimal training program for new entrants in this division?

Answer. The Division has procedures for training new as well as its senior staff. We are presently devoting increased staff years to training in fiscal 1985 as compared to the 2.8 staff years spent during fiscal year 1984. An in-depth training program was conducted for new employees in August 1984.

On-going training is conducted for the staff as the result of topical matters, such as changes in disclosure requirements, Rule or Form changes, accounting developments and emerging issues. In addition, the Division has developed various manuals to facilitate staff knowledge and consistency of procedures in dealing with filings.

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Part c. In the early 1970's when the Commission created the integrated disclosure system the Form 10-K annual report became the cornerstone disclosure document. The theory was that since seasoned companies file periodic reports, including the 10-K, why not just incorporate such documents (without delivering them) into the prospectus used to sell securities so that the costs and time spent could be reduced. The SEC claimed that its objective would be to concentrate more of its efforts on reviewing periodic reports, especially 10-K's.

* How many 10-K's are reviewed by the staff?

Answer. During FY 1980, the first stage of the integrated disclosure system was adopted. This action included revision of the annual report (Form 10-K) to facilitate incorporation by reference of that report in Securities Act filings. During FY 1980, of the 8,344 10-K's filed, 417 were fully reviewed. During fiscal year 1984, 9,374 10-K's were received. Of those, 1,283 or 13.7% were fully reviewed. It is currently projected that of the 10,550 10-K's expected to be filed during fiscal year 1985 1,951 (18.5%) will be fully reviewed.

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Part d.

* How many comment letters have been issued on 10-K's?

Answer. During the fiscal year ended September 30, 1984 930 comment letters were issued on Form 10-K filings.

Part e.

* Does the Division of Corporation Finance need more staff to review periodic reports on a regular basis?

Answer. During 1984, the Division of Corporation Finance reorganized to, among other things, improve support to the integrated disclosure system primarily through increased reviews of Form 10-K's. Additional resources were allocated to the review function of the Full Disclosure Program. The number of review Branches was increased from ten to twelve.

Based upon currently projected workload for fiscal year 1986, it is felt that present staffing together with anticipated benefits stemming from our efforts toward automation, continued regulatory simplification and procedural efficiencies will be sufficient to discharge the Division's statutory mandate.

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Question 5. Staff Turnover.

Part a. What was the staff turnover rate at the Commission in 1984?

Answer. The overall turnover rate at the Commission in 1984 was 16.9%. The turnover rate by occupation at the Commission in 1984 was as follows:

Attorneys	20.6%
Financial Analysts	9.3%
Accountants	9.3%
Clerical/Support	27.3%
Securities Compliance Examiners	15.1%
Investigators	6.7%

Part b. What are you doing to encourage career advancement at the Commission and to retain a professional staff at mid-levels?

Answer. The Commission has taken several steps to recognize and retain its mid-level professional employees. For example, the Commission:

- (1) encourages new professional staff to make a three-year commitment to the Commission;

- (2) promptly effects merited promotions, reassignments and other personnel actions for its mid-level staff;
- (3) dedicates a significant amount of funds for incentive awards to mid-level staff based on their performance (in 1985, \$162,000 has been earmarked for this group);
- (4) makes a special effort to recognize its staff by giving them honorary awards in formal ceremonies and by nominating them for honorary awards that are sponsored by organizations external to the Commission;
- (5) runs a very successful training program for new supervisors and managers to assure that they have the skills required to manage successfully; and
- (6) conducts in-house courses for its mid-level staff on stress and "burn-out" avoidance.

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Question 6. Investment Management Regulation

Part a. In various public statements during the last several years, you have indicated the view that a legislative proposal should be prepared to amend the Investment Company Act of 1940.

Could you give us some idea of the types of changes to the Investment Company Act of 1940 you believe are necessary? More specifically, in what areas do you believe the Commission's efforts to regulate (or deregulate) the mutual fund industry under the Commission's existing administrative authority have been unsuccessful?

Answer. The staff has just started to study what changes, if any, need to be made in the Investment Company Act of 1940. As you know, that Act was designed to regulate a vastly different industry from the one which exists today. While some amendments have been made to the Act, and the Commission has adapted the Act to situations unforeseen in 1940 by rule and exemptive order to the extent of its authority, to date no comprehensive review has been undertaken on this 45 year old regulatory structure. A necessary part of the staff inquiry will be to determine where problems exist that the Commission does not have the power to correct by administrative action. It is premature now to list the types of changes the Commission may decide are necessary at the conclusion of the staff inquiry.

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Investment Management Regulation

Part b. Has the Commission given any thought to creating a self-regulatory organization similar to the NASD for the investment adviser industry which would set qualifications standards and establish rules of fair practice under which violators could be disciplined by the organization?

Answer. There have been no formal proposals to or from the Commission concerning the establishment of a self-regulatory organization ("SRO") governing investment advisers. While there is no ongoing staff project considering this issue, we expect to receive a proposal to establish an SRO for financial planners from the International Association of Financial Planners later this year.

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Investment Management Regulation

Part c. Rule 12(b)1 under the Investment Company Act allows a fund to pay for distribution of its shares if the disinterested directors find that it is advantageous for the fund to do so. In recent months there has been a proliferation of 12(b)1 plans in which the cost to funds for distribution have increased to the point where such costs could approach or even exceed the investment management fees.

Is the Commission concerned about this?

If so, what measures are being taken to alleviate this possible abuse?

Answer. The Commission adopted Rule 12b-1 in 1980 following a lengthy public rulemaking proceeding. The rule permits mutual funds to spend fund assets to finance activities that promote the sale of fund shares, provided that extensive procedural steps are followed. All distribution payments must be made pursuant to a plan which, among other things, must be approved by shareholders and by the fund's board of directors and by its independent directors. The number of funds that have adopted Rule 12b-1 plans has steadily increased since 1980. As of the end of 1982, approximately 100 funds had adopted 12b-1 plans; as of the end of 1983, the number had increased to 250 and at the end of 1984, the number was about 375. There are approximately 1600 registered mutual funds.

Expenditures under Rule 12b-1 plans vary depending upon the nature of the fund and the distribution activities to be financed. For example, the average plan expenditures by money market funds approximate .25% of average net assets. Equity funds generally provide for larger expenditures but average about .50%.

The Commission's staff has been following developments under Rule 12b-1. Staff concerns to date have focused primarily on making sure that mutual fund prospectuses adequately disclose the existence of 12b-1 plans and the amount of fund assets that the fund contemplates spending. In November 1984, the Commission proposed for comment several changes to registration form for mutual funds to improve the quality of prospectus disclosure in this area. The Commission will consider staff recommendations this fall on whether to adopt the proposed changes.

Although a few 12b-1 plans permit expenditures in excess of advisory fees, the staff is not inclined to recommend that the Commission regulate the amount that can be spent on distribution activities. For the present, the staff believes the Commission should avoid rate making in this area because the marketplace should exercise a reasonable measure of discipline. Fund distribution expenditures can, of course, adversely affect performance if expense ratios do not improve as the fund increases in size. The fund may then lose existing and prospective shareholders. It may, however, ultimately be necessary to consider limiting the kinds of distribution activities that can be paid for with fund assets. It may also prove desirable to remove any procedural requirements of the existing rule whose value is outweighed by their cost to fund shareholders.

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Investment Management Regulation

Part d. In view of the Commission's heavy burden of enforcement, will the Commission recommend legislation to give individuals a private right of action under the Investment Advisers Act?

Answer. While a limited private right of action exists under the Investment Advisers Act, the Commission has not considered whether to make a legislative recommendation on private rights of action. The Commission may, however, consider such a recommendation; particularly, if other legislative action under the Advisers Act becomes necessary. On June 10, 1985, the Supreme Court in Lowe v. SEC (No. 83-1911) held that Christopher Lowe and his companies could not be enjoined from publishing their impersonal investment advice, notwithstanding the fact that the Commission had revoked their investment adviser registration. The Court reasoned that Lowe's investment advisory publications were exempt from the Advisers Act under the exclusion in Section 202(a)(11)(D) of the Act for a "bona fide newspaper, news magazine, or business or financial publication of general and regular circulation." The Court's approach removed the Commission's statutory authority to apply any of the provision of the Act, including its anti-fraud provisions, to most advisory publishers. Because of the Court's decision, the Advisers Act may need to be revised in some respects. In addition, a trade association for financial planners is considering whether to develop a legislative recommendation that would amend the Advisers Act to establish a self-regulatory organization for financial planners under the Commission's oversight. If such a legislative package is developed, the private rights issue also might be raised.

In view of the steady growth in the number of registered investment advisers, the staff is studying whether it continues to be necessary to regulate, on the federal level, all advisers currently registered with the Commission. It may be that some of those advisers could be regulated adequately by the states. If statutory changes in this regard were to be made, the role of private rights of action would be a pertinent consideration.

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Investment Management Regulation

Part e. Rule 12d3-1 under the Investment Company Act was amended last summer to increase greatly the circumstances under which mutual funds can invest in broker-dealers. In approving this amendment did the Commission consider whether there might be any conflict between a mutual fund adviser's duty to select the best available investments for the fund on the one hand, and the adviser's desire to stay on the good side of dealers in fund shares on the other hand?

Answer. Yes.

In proposing and adopting Rule 12d3-1 and related disclosure requirements, the Commission did consider the potential conflicts of interest that may arise if an investment company is able to acquire securities issued by its regular brokers or dealers. */ We believe that these potential conflicts are addressed by the qualitative and quantitative

*/ The Commission recently adopted Rule 10b-1 to define the term "regular broker or dealer." See Investment Company Act Release No. 14193, dated October 12, 1984. That rule states that an investment company's regular brokers or dealers include: the ten brokers or dealers that received the greatest dollar amount of brokerage commissions by virtue of direct or indirect participation in the company's portfolio transactions during the company's most recent fiscal year; the ten brokers or dealers that engaged as principals in the largest amount of portfolio transactions of the investment company during the company's most recent fiscal year; and the ten brokers or dealers that sold the largest dollar amount of securities of the investment company during the company's most recent fiscal year.

conditions of the revised rule and by new registration statement and periodic reporting requirements. **/

Under the revised rule, an investment company may acquire securities issued by a person that has derived more than 15% of its gross revenues from securities related activities only if those securities are equity securities that meet the Federal Reserve's margin requirements or debt securities that are determined to be investment grade by the investment company's board of directors. While this condition does not prevent an investment company from acquiring the securities of one of its regular brokers or dealers, it minimizes the company's ability to make a bad investment just to stay on the good side of that broker or dealer. **/

The revised rule also limits the amount of securities of any one issuer that an investment company may acquire where the issuer derives more than 15% of its gross revenues from securities related activities. Under the rule, an investment company may invest no more than 5% of the value of its total assets in the securities of any one issuer. Further, the company's investment in the equity securities of that issuer cannot exceed more than 5% of the outstanding securities of that class; neither

*/ See Investment Company Act Release Nos. 13725, dated January 17, 1984, proposing revised Rule 12d3-1 and 14036, dated July 13, 1984, adopting the revised rule.

Where the regular broker or dealer is an affiliate of the company's investment adviser principal underwriter or promoter, there could be no potential conflict of interest because paragraph (c) of the rule makes exemptive relief unavailable for investment company acquisitions of the securities issued by those entities or their affiliates.

**/ Under the Rule, an investment company is prohibited from acquiring the securities.

can the company's investment in the debt securities of that issuer exceed more than 10% of the principal amount of debt outstanding. Again, although this condition does not prevent an investment company from acquiring securities issued by one of its regular brokers or dealers, it does prevent the company from loading its portfolio with those securities just to stay on the firm's good side.

At the time that revised Rule 12d3-1 was adopted, the Commission also amended investment company registration statement forms to require the registrant to identify any regular broker or dealer (or its parent if the parent derives more than 15% of its gross revenues from securities related activities) whose securities the registrant acquired during the most recent fiscal year. The new registration statement items also require the registrant to disclose the value of the registrant's aggregate holdings of that issuer's securities as of the close of the registrant's most recent fiscal year. The Commission incorporated complementary disclosure requirements in a new semi-annual reporting form for investment companies. */ which requires the company to disclose its aggregate securities holdings at the end of the reporting period.

These disclosure requirements were designed to give shareholders and the Commission a complete picture of the extent to which investment companies are relying on the revised rule to acquire securities issued by their regular brokers or dealers. Disclosures to date indicate that only a handful of registrants have made such acquisitions. We intend to

*/ See Investment Company Act Release No. 14299, dated January 4, 1985, adopting Form N-SAR.

monitor the situation closely, however, and will re-examine the rule's conditions if it appears warranted.

Wholly apart from these regulatory controls, it should be remembered that the mutual fund industry is highly competitive, and a fund's portfolio manager has a strong incentive to resist making unwise investments in securities issued by any broker-dealer, because of the potential adverse impact this may have on the fund's performance and attractiveness to investors.

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Question 7. Options Trading.

The SEC has long-forbidden side-by-side trading of stocks and options for fear of stock manipulation and other market abuses but recently you authorized six exchanges to trade options on over-the-counter stocks and conditionally allowed the National Association of Securities Dealers to conduct a pilot project in over-the-counter options trading.

Why the change in the Commission's position? What makes today's climate any different from in the past?

Answer. The Commission has not yet authorized any exchange or the National Association of Securities Dealers ("NASD") to trade options on over-the-counter ("OTC") stocks side-by-side with the stocks underlying such options (so-called "integrated market making"). As is more fully described in the Commission's release approving the trading of OTC options products by the exchanges and the NASD ("OTC Options Release"), the Commission only approved, in concept, a one-year pilot program in integrated market making for OTC market makers in the six most active OTC stocks if (1) the Commission determines in a separate proceeding both to grant exchanges unlisted trading privileges in these stocks and to approve integrated market making on exchanges in these six stocks; and (2) equity and options audit trails are in place prior to the commencement of this pilot.

The Commission determined that a number of benefits might be obtained through a pilot program in integrated market making. In particular, the Commission believes permitting integrated market making may improve the quality of the markets for stocks and its related option. In addition, the Commission was cognizant of the fact that the prohibition on integrated market making might substantially affect the NASD's ability to compete for market share with the exchanges in these options.

In making this decision, the Commission also was cognizant of changes in the OTC market since the Commission's Option Study. First, there is last sale reporting on all OTC stocks eligible for options trading, permitting much more effective monitoring by investors of trading activity in both the option and underlying stock. Second, the NASD's developing audit trails for both OTC options and the stocks underlying them, permitting far more efficient surveillance of manipulative or abusive activity involving the option of underlying stock.

Notwithstanding these major advances in the OTC market, the Commission chose to limit its pilot in integrated market making to the six most actively traded OTC stocks. In light of the intensive competition and dispersion of market share in these six stocks, the Commission believed that there were not significant risks that integrated trading would result in manipulative or abusive trading activity.

RESPONSE TO QUESTION OF SENATOR PROXMIRE,

Hearing of April 17, 1985

Question 8. New products.

Part a. With the proliferation of new and complex products and the opportunity for more ingenious fraudulent activities, do the SEC regional offices have enough resources.

Answer. Yes. The proliferation of new and complex products in the securities context is a development which the Commission's regional offices are addressing in their enforcement and inspection programs. While these innovations present a definite challenge for both our field and home office units and do place increasingly difficult demands on their resources, it is our belief that the staff currently is fulfilling its responsibilities in this regard. Although one could always do more with more, the present staff has embarked on a concerted effort to maximize its productivity through, among other things, greater utilization of computers, streamlined examination procedures, improved case selection techniques, enhanced targeting of inspections and expanded access to data relating to the entities registered with the Commission. Continuing efforts are also underway to familiarize both our home office and field office staff with the new investment vehicles coming on-line with which they must deal. The positive results of this

push for greater efficiency in our operations have been evidenced by higher numbers of enforcement actions filed, filings examined and examinations conducted.

Part b. Also, are the regional offices able to employ the sophisticated and experienced staff necessary to protect the public with respect to these new products?

Answer. Yes. The SEC, including its regional offices, has been fortunate in that it has been able to attract an extremely competent professional staff. The Commission's high reputation for quality, sustained over the years, has facilitated efforts to recruit top graduates from colleges and business and law schools. The Commission has experienced turnover among its professional staff, more so in certain parts of the country than others. The widening gap between public sector and private sector salaries also has had an impact. Notwithstanding these factors, however, the SEC has maintained a core of sophisticated and experienced employees who, coupled with the fresh talent coming into the Commission each year, have given the agency an effective, motivated workforce capable of providing an appropriate level of public protection.

RESPONSE TO QUESTION OF SENATOR PROXMIRE

Hearing of April 17, 1985

Question 9. Global Trading Systems

In your budget submission you state that, "with the emergence of global securities markets, the Commission will be confronted by a number of important policy issues." What are some of the important policy issues you are referring to and how do you plan to address them?

Answer. Important policy issues raised by the internationalization of the securities markets include (1) ways of ensuring adequate investor protection in the face of the emergence of global trading; (2) ways of facilitating multinational offerings in the U.S. and other countries; and (3) the development of efficient trading markets across national borders.

(1) The Commission is engaged in a number of ongoing efforts intended to ensure adequate investor protection in the face of the internationalization of the securities markets. Protecting investors is considerably more difficult in an international context. For one, the surveillance mechanisms in place in our domestic markets are more extensive than those abroad. The Commission's investigative subpoena authority is limited to persons within the United States. And it is often difficult to obtain information regarding transactions effected through banks and securities firms located in countries with secrecy or blocking laws. Commission programs and actions to deal with these problems of investor protection include the following.

First, the Commission has taken steps to ensure that foreign issuers seeking access to the U.S. capital markets provide adequate disclosure to U.S. investors. The Commission in 1979 adopted Form 20-F, a consolidated registration statement and annual report for foreign private issuers, and in 1982 adopted an integrated disclosure system for such issuers.

Second, the Commission and the self-regulatory organizations under its oversight provide electronic and other surveillance and a substantial enforcement presence in the United States securities markets designed to ensure that insider trading, manipulation and other securities misconduct is detected, whether by foreign or domestic entities.

Third, the Accord concluded with Switzerland in 1982 removes the haven of the Swiss secrecy laws from those who would trade on inside information. The Swiss Accord, while limited to insider trading in cases of tender offers, is an historic precedent for developing cooperative means for obtaining information from foreign jurisdictions.

Fourth, the Commission is pursuing cooperation with other foreign countries on enforcement issues, and is considering various alternative to ease enforcement difficulties in cases involving foreign nationals.

Fifth, the Commission is litigating enforcement actions against persons engaging in insider trading through foreign entities, including trading in the securities of Santa Fe International Corp. and St. Joe Minerals Corporation. In both

cases, the Commission used U.S. Court process and mutual assistance agreements to obtain information regarding the identities of the persons involved who had traded through Swiss banks.

(2) In March 1985, the Commission issued a release (Release No. 33-6568) seeking public comment on issues involved in multinational securities offerings. The release sets forth two conceptual approaches to harmonizing disclosure and distribution practices for such offerings in the United States, the United Kingdom, and Canada. Under the first, the "reciprocal" approach, all three countries would agree that a prospectus accepted in an issuer's domicile that meets certain standards would be accepted for offerings in each of the other participating countries. Under the second, the "common prospectus" approach, the participating nations would attempt to develop a common prospectus to be simultaneously filed with each country's securities regulators. The United Kingdom and Canada were chosen for consideration because their issuers use the U.S. capital markets frequently, they share a common language with the United States, and their disclosure requirements most closely resemble those of the United States. Specific questions are posed for comment. Either approach will require close cooperation with government officials in Canada and the United Kingdom, as well as with the states. The concept release provides a framework for public comment and, hopefully, fruitful dialogue.

(3) In April 1985, the Commission issued a release soliciting public comment on a variety of issues relating to the operations of the international securities markets. Among the issues on which comment was requested were:

- the need to facilitate international trading;
- alternative market structures, such as simultaneous trading in different national markets, increased coordination between domestic and foreign markets, and "around-the-clock" in-house trading;
- whether arbitrage activity will be sufficient to reduce pricing disparities in multiple market trading or whether intermarket linkages are preferable;
- linkage of international securities clearance and processing facilities;
- cooperation between national regulatory bodies in all of these areas.

This release is intended to provide a forum for consideration of the issues raised by the internationalization of trading markets and for a discussion of the manner in which global trading markets should develop.

RESPONSE TO QUESTION OF SENATOR WILLIAM PROXMIRE

Hearing of April 17, 1985

Question 10. International Accounting Standards

What concrete efforts have been made by the SEC to integrate international accounting standards and securities trading practices?

Answer. The International Accounting Standards Committee (IASC) is the only world-wide standard setting body. Professional accounting bodies in some fifty countries, including the American Institute of Certified Public Accountants, are now members of that body. IASC members agree to use their best endeavors to ensure that auditors satisfy themselves that international accounting standards are complied with in all material respects.*/
In light of the relatively advanced state of the financial accounting and reporting models in the United States, no material differences have occurred between the requirements of the United States and the IASC. Therefore, it has been unnecessary for the SEC to take any direct action to integrate international accounting standards in the United States. The SEC has, however, assumed an active role in efforts to the promote the international harmonization of financial accounting and reporting standards.

*/ IASC standards attempt to narrow differences in the measurement of the elements of financial statements by narrowing available alternatives. Such narrowing process often results in the endorsement of one or more acceptable methodologies in an IASC standard.

The Office of the Chief Accountant maintains communications with various national and international standard-setting bodies and comments on the proposed standards of such bodies from time to time. A staff member from the Office serves as the United States' representative to regular meetings of working groups on international accounting and reporting standards established by the United Nations and the Organisation for Economic Cooperation and Development (OECD).

The OECD sponsored an international forum on the harmonization of accounting and reporting standards in April 1985. The U. S. delegation to the forum included, in addition to its regular members, the Chairman of the Financial Accounting Standards Board, a corporate executive, a partner of a major accounting firm and two staff members of the General Accounting Office. The delegations from other OECD-member countries also included representatives of standard setting bodies, as well as users and preparers of financial statements.

The harmonization of accounting standards is a long-term process; ongoing efforts are expected to continue and should favorably affect the efficiency of world capital markets.

RESPONSE TO QUESTION OF SENATOR PROXMIRE

Hearing of April 17, 1985

Question 11. Settlement Period.

Is the SEC undertaking any sort of study about whether the traditional five-day settlement period for securities traders can be shortened or accomplished on a real-time basis?

Answer. No. This subject was discussed at the Division of Market Regulation's April 1984 Securities Processing Roundtable. Participants there concluded that efforts to shorten the traditional five-day settlement period likely would create more problems than benefits, at least near-term. Discussions, nevertheless, have continued in the industry, and SEC staff have sought to encourage those conversations. Indeed, clearing agencies have been studying ways to enhance securities processing that would enable the industry to evolve toward shortened "regular-way" trade settlement. These enhancements include earlier clearing corporation guarantees of settlement obligations (currently these arise on the fourth day after trade date) and earlier corresponding mark-to-the-market payments (currently these also are required on that day). Moreover, in cooperation with the clearing agencies, the national securities exchanges and the National Association of Securities Dealers, Inc. have established small order automated execution systems that effectively "lock-in" the terms of each trade. These systems thus eliminate the need for comparison processing and therefore the SEC is and will continue to coordinate securities industry efforts to

improve efficiency and safety within the National Clearance and Settlement System. For example, rules of the Midwest Stock Exchange and the Pacific Stock Exchange, approved by the SEC, already allow next-day settling trades. Also, the New York Stock Exchange currently is operating, under SEC oversight, a program that allows next-day settling trades. Finally, the Commission has hosted industry meetings focused on advancing within the five-day cycle certain predicates to actual settlement. These include earlier clearing corporation guarantees of settlement obligations (currently these arise on the fourth day) and earlier mark-to-the-market payments (currently these are required also on the fourth day). Real-time processing already is possible for the comparison stage of some trades, especially trades executed on automated execution systems.

RESPONSE TO QUESTION OF SENATOR PROXMIRE

Hearing of April 17, 1985

Question 12. Internationalization

How does the Commission use its membership in the International Association of Securities Commissions and Similar Organizations to enhance cooperation among countries in enforcing securities laws?

Answer. The Commission has found its membership and participation in the International Association of Securities Commissions and Similar Organizations very helpful in enhancing cooperation among participating countries and at minimal costs. The principal benefits are threefold: (1) it provides a forum for enhanced understanding of the securities regulations and markets of the participating countries; (2) it has proved helpful in cross-border investigations; and (3) it is a natural link to the world's securities markets.

The Association is the only international forum of its kind where high level delegations of securities market regulators can share views and experiences concerning the development, improvement, promotion, expansion, and regulation of their securities markets. By participating in the conferences, the Commission improves its relationships with other countries through a dialogue designed to aid in the exchange of information and experiences.

As an outgrowth of this exchange, the Commission has developed informal relationships with law enforcement agencies

in a number of countries which facilitate mutual access to information. On various occasions, these relationships have resulted in the Commission obtaining access to information and assistance in cross-border investigations that would not otherwise have been available or available on a timely basis.

The resolutions approved at the annual conferences are considered important policy guidelines, even though they are not binding on members. The Commission's delegates to the annual conferences have been very influential in the formation of these resolutions. On request, the Commission's staff has studied and helped in the development of securities laws of several developing countries. We have also provided hands-on training for the professionals of various securities commissions. As a result of such activities other member countries variously have used the federal securities laws and regulations as a model for their own markets. Thus, the Organization has provided yet another facility for the development of an interface of various securities markets, a necessary element in the inevitable internationalization of the free world's capital markets.

RESPONSE TO QUESTION OF SENATOR PROXMIRE

Hearing of April 17, 1985

Question 13. Soft dollars.

What abuses, if any, have taken place in the "soft dollar" sector and what regulatory action, if any, do you contemplate taking?

Answer. Under Section 28(e) of the Exchange Act, a money manager will not be deemed to have violated any fiduciary duty solely because he causes an account to pay more than the lowest available commission rate if he makes a good faith determination that the rate paid was reasonable in relation to the value of research and brokerage services provided by the broker executing the transaction. In 1976, the Commission issued an interpretive release on various issues under Section 28(e). Among other things, the Commission stated that goods and services that were "readily and customarily available and offered to the general public on a commercial basis" did not constitute research. Thus, a money manager that purchased such things as magazine and newspaper subscriptions, airline tickets and quotation equipment with commission dollars (i.e., so-called "soft dollars") could not claim the protection of Section 28(e).

Over the past eighteen months, the Commission and its staff have been advised that there are some abuses occurring in the area. For example, in purported reliance on Section 28(e), some money managers are paying for investment seminars in foreign countries, along with the cost of airfare, hotels and

meals, in soft dollars. This practice is clearly inconsistent with Section 28(e) and may involve violations of the antifraud provisions of the federal securities laws. The Commission's staff has conducted several inspections of broker-dealers and money managers to detect abuses. Where appropriate, the Commission will take enforcement action. The Commission's staff is also in the process of preparing an interpretive release to provide guidance in some of the "gray" areas under Section 28(e).

RESPONSE TO QUESTION OF SENATOR PROXMIRE,

Hearing of April 17, 1985

Question 14. Public Utility Holding Company Act.

Part a. What is the basis for your statement in the budget submission that "The Commission anticipates positive action on the repeal of the Public Utility Holding Company Act?"

Answer. Since the Commission first voted in favor of PUHCA repeal in 1981, support for the measure has grown. The President has indicated his backing for the measure by including PUHCA repeal in his legislative program for 1985. Moreover, Vice President Bush's Task Group has endorsed repeal as a step towards improving the regulation of the financial services industry. With this level of support, it is appropriate to factor repeal into the Commission's fiscal 1986 planning.

RESPONSE TO QUESTION OF SENATOR PROXMIRE,

Hearing on April 17, 1985

Public Utility Holding Company Act

Part b. What impact did OMB have in the Commission's eliminating all twenty positions in the Division of Public Utility Holding Company Regulation?

Answer. As a result of a management study conducted by the Commission's Office of the Executive Director in 1984, the Division of Public Utility Holding Company Regulation was reorganized and merged into the Division of Investment Management. The staff was reduced by six positions to reflect a declining workload (the number of filings processed has declined 54% since 1980) and to recognize efficiencies in program management and administration that could be achieved by merging the program into Investment Management. As a result of the study, the staff was reduced to 13 positions.

In preparing the 1986 budget, OMB directed the agency to eliminate the remaining 13 positions because of the expected repeal of the Act in fiscal 1985.

RESPONSE TO QUESTION OF SENATOR PROXMIRE,

Hearing on April 17, 1985

Public Utility Holding Company Act

Part c. Was this the initial SEC recommendation and position or an OMB directed policy?

Answer. The Commission's 1986 budget request to OMB did not assume repeal of the Public Utility Holding Company Act in fiscal 1985. OMB, reflecting the expectation of PUCHA repeal in 1985, directed the agency to delete the funding and positions for the program, a decision which the agency unsuccessfully appealed.

RESPONSE TO QUESTION OF SENATOR PROXMIRE

Hearing of April 17, 1985

Question 15. Rule Changes.

What percentage of the proposed rule changes filed by self-regulatory organizations are acted upon by the Commission within the 90 period established in the Exchange Act?

Answer. For the period beginning October 1, 1983 through December 31, 1984, self-regulatory organizations filed 416 proposed rule changes with the Commission pursuant to Section 19(b) of the Securities Exchange Act of 1934. Approximately 85 percent were acted on within 90 days of publication in the Federal Register. The remaining 15 percent of the proposed rule changes (for which the self-regulatory organizations agreed to an extension of time for Commission action beyond 90 days) generally involved complex or controversial issues requiring the self-regulatory organizations to respond to issues raised by the Commission or the public, and requiring additional time for the Commission to adequately consider and act upon the issues presented.

RESPONSE TO QUESTION OF SENATOR PROXMIRE,

Hearing of April 17, 1985

Question 16. Fees.

Part a. I see from your budget submission that in 1985, the SEC expects to collect 119 percent of its operating expenses from fees and in 1986, the SEC expects to collect 128 percent of its operating expenses from fees.

You point out that in 1986 "the \$10 million revenue increase is expected to largely result from a resumption of the historical growth rate in securities transaction volume of 27 percent per annum."

According to the figures you have submitted to us, in 1986 you are asking for a budget appropriation of \$107,267,000, which is essentially a budget freeze, while at the same time you estimate the Commission will receive a total of \$137,445,000 in fees.

Do you see any correlation between increased fee income and increased workload at the Commission?

Answer. There is a correlation between fee income and Commission workload. A large percentage of the Commission's fee income (a projected 66% in 1986) is generated by fees associated

with registrations under the Securities Act of 1933, other filings and reports. An increase in these fees reflects an increase in the registrations, other filings and reports which much be processed by SEC staff. Other Commission fees arise from transactions under the Securities Exchange Act of 1934. (It is these fees which account for 94% of the projected \$10 million fee increase in 1986.) Economic recovery and the attendant increase in securities market activity creates more opportunities for fraud and other securities violations, however, it is difficult to correlate these fees with the Commission's actual enforcement and regulatory workload.

Part b. Wouldn't it make sense to plow some of this increase in fee revenue back into the Commission especially since the Commission would still be self-supporting?

Answer. The Commission's proposed budget for 1986 is sufficient for the Commission to discharge its statutory mandate.

This question raises the issue of the relationship between the agency's fee income and its appropriations. To attempt to adjust the Commission's appropriations to its fee income is a difficult proposition and historically ill-advised. Fees will always fluctuate with such factors as the volume of business transactions which may be unrelated to the Commission's budget needs. Considered as a percentage of appropriation, fees

have varied widely during the SEC's 50-year history. In 1943, fees amounted to only 3.9% of the agency's appropriation, while in 1984, fees reached 129% of the agency's appropriation. In the past six years alone, fee collections have ranged from a low of 42% of the agency's appropriation in 1978 to a high of 129% of the appropriation in 1984.

Part c. Explain to me why should the Commission be a revenue raiser for the government?

Answer. The Commission should not be a revenue raiser for the government. Current high fees reflect a remarkable level of market activity that will not be sustained over the long run. Fees have fallen short of appropriations in 47 of the SEC's 50 years. In the three years 1969, 1983 and 1984, fees exceeded appropriations by 18%, 10% and 29% respectively. Over the Commission's 50-year history, however, fees have accounted for only 68% of the SEC's appropriations.