ORAL STATEMENT OF DAVID S. RUDER
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION
BEFORE THE SENATE SUBCOMMITTEE ON SECURITIES OF THE
SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

CONCERNING THE COMMISSION'S AUTHORIZATION REQUEST
FOR FISCAL YEARS 1990-92

April 18, 1989

Chairman Dodd and Members of the Subcommittee:

Thank you for this opportunity to present an overview of the Securities and Exchange Commission's ongoing efforts and to discuss its authorization request for fiscal years 1990, 1991, and 1992. I request that the Commission's written statement and its previously submitted authorization request be included in the record.

In recent years, the number and magnitude of the tasks faced by the Commission have grown dramatically, while its staff has grown very little. Additional resources are needed to ensure that the Commission can effectively exercise its statutory responsibilities. The Commission's authorization request is intended to provide the agency with the resources needed to regulate effectively the nation's securities markets.

Since its creation in 1934, the Commission has played a major role in protecting the integrity of the nation's securities markets. Over the next several years, the Commission will face even greater challenges. The securities markets are becoming more internationalized and interdependent. Financial instruments are increasingly complex and the securities industry is undergoing a period of rapid growth. The authorization sought by the

Commission will strengthen its ability to plan and carry out its programs.

Each of the Commission's four major programs requires additional resources over the next three years to meet its responsibilities.

The Commission's Enforcement staff continues to enforce the federal securities laws vigorously, as exemplified by the recently-settled case against Drexel Burnham Lambert. However, increases in the Commission's workload, without sufficient increases in its resources, could hamper the Commission's enforcement efforts. In particular, the number of investor complaints has risen dramatically, and securities investigations and litigation have become more complex. Moreover, the Commission is mobilizing its efforts against penny stock fraud and market manipulation. Additional resources are needed to permit the Commission to meet all of its enforcement objectives.

The Commission's Market Regulation staff is also experiencing serious resource limitations. From 1980 to 1988, there has been an estimated 88% increase in the number of registered broker dealer firms, and an estimated 145% increase in the number of registered representatives. Yet the Division's staff years during the same period actually declined. The Division needs additional resources so that it can adequately regulate broker-dealer firms and supervise the nation's securities markets. Additional resources are also required to establish a vitally needed capital markets unit and to implement

Commission initiatives arising out of the October 1987 market break. The Commission also has proposed certain measures to address regulatory issues in the municipal securities market.

The Commission's Full Disclosure staff reviews disclosure filings from approximately 14,000 public companies. From 1980 to 1988, there was a 135% increase in the number of filed registration statements, and a 175% increase in the number of filed merger proxies. The transactions and securities under consideration have become more complex. The staff needs greater resources to review disclosure filings and to address disclosure and other issues raised by leveraged buyouts and other takeover activities. Support is also needed for the implementation of EDGAR -- the Commission's electronic filing system for disclosure documents. Finally, if the Administration's proposal that the Commission regulate certain bank and thrift securities is adopted, the Commission will need additional resources to meet these new responsibilities.

The Commission's Investment Management Program, which supervises the mutual fund industry, investment advisers, and public utility holding companies, is also experiencing significant resource limitations. From fiscal year 1980 through fiscal year 1989, the number of registered investment companies will have increased by an estimated 146%, and the number of registered investment advisers will have increased by an estimated 217%. However, the Commission's examination staff has not increased significantly since 1980. Additional resources

are needed to permit this program to continue to perform its inspection and regulatory responsibilities.

In addition to these four programs, the Commission must have access to experienced legal services. These services are provided by the Commission's Office of the General Counsel. This Office represents the Commission in all appellate litigation and defends the Commission in suits challenging the agency's rulemaking and other orders and enforcement authority. The Office also prosecutes disciplinary proceedings against professionals who practice before the Commission. The increased level of Commission enforcement activity will continue to place additional burdens on the Office's staff. This Office is also primarily responsible for preparing the Commission's legislative proposals and providing legislative drafting and other assistance to Congress. Congressional and Commission interest in legislation affecting the securities markets requires that this Office have adequate resources.

The Commission recognizes that Congress faces significant constraints in providing adequate funding for federal programs. I believe, however, that the Commission's authorization request is justified by the important statutory responsibilities with which the agency has been entrusted by Congress.

Thank you, Mr. Chairman.

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April 18, 1989

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April 18, 1989

Chairman Dodd and Members of the Subcommittee:

The Securities and Exchange Commission appreciates this opportunity to present an overview of its ongoing efforts as well as to discuss the Commission's authorization request for 1990-92 and its need for additional resources. The Commission requests that the separate statement setting forth the Commission's 1990-92 authorization request, previously submitted to this Subcommittee, be included in the record.

I. INTRODUCTION AND EXECUTIVE SUMMARY

In recent years, the number and magnitude of the tasks faced by the Commission have grown dramatically, while its staff has grown very little. The Commission's operations are efficient, but its resources are strained. Additional resources are needed to ensure that the Commission can continue to exercise effectively its statutory responsibilities. This 1990-92 authorization request is intended to provide the Commission with the resources needed to regulate the nation's securities markets.

The Commission seeks a three-year statutory authorization for appropriations in the following amounts: $178.0 million for 1990, $212.6 million for 1991, and $238.1 million for 1992.

Since its creation in 1934, the Commission has played a major role in protecting the integrity of the nation's securities markets. Over the next several years, the Commission will face great challenges to its ability to protect these markets. These challenges include the need to maintain and expand the Commission's vigorous enforcement program, the problem of fraud in the penny stock market, continued growth of the securities industry, increasing complexity of financial instruments and techniques, increasing interdependence of the financial markets, and the requirements of intergovernmental and interagency coordination and cooperation resulting from the internationalization of the markets. The Commission also needs to continue the computerization of its operations. Implementing the Commission's programs in all of these areas requires long-range planning, extensive study, and carefully measured implementation. The three-year authorization sought by the Commission will strengthen the Commission's ability to plan and carry out its programs.

Commission activities are organized around four programs: Enforcement, Market Regulation, Full Disclosure, and Investment Management Regulation. Each of these programs requires additional resources over the next three fiscal years if it is to meet the Commission's important statutory responsibilities for the protection of investors and the maintenance of orderly markets.

The Commission's Enforcement program is responsible for investigating possible violations of the federal securities laws and initiating civil injunctive actions and administrative disciplinary proceedings when evidence of violations is found. The Commission's enforcement staff continues to exercise this mandate vigorously. Sales on United States securities exchanges totaled approximately $1.8 trillion in 1988, as compared with approximately $.7 trillion in 1982. Likewise, the volume of investor inquiries has increased significantly. In 1987, the Commission received 230% more complaints and inquiries from investors than it did in 1982. The National Association of Securities Dealers reported receiving approximately 340% more complaints in 1987 than in 1982. Moreover, in 1988, the Commission experienced an additional 22% increase in the number of investor complaints and inquiries, with a total number of 49,000 received that year. Commission resources, however, have not kept pace. In addition, the Commission now devotes a greater percentage of resources to complex litigation and matters involving foreign trading, which further strain the limited resources available for more routine but nevertheless important enforcement matters. Without additional resources, the Commission's enforcement staff will be unable to maintain its current pace of enforcement actions while at the same time devoting sufficient resources to its recent crackdown on penny stock fraud and manipulation.

The Division of Market Regulation is responsible for the regulation of broker-dealer firms and the supervision of the Nation's securities markets. From 1980 to 1988, there has been an estimated 88% increase in the number of registered broker-dealer firms and an estimated 145% increase in the number of registered representatives, while the Division's staff years during the same period actually declined. The Division needs additional resources over the next three years to enable it to perform its supervisory functions, to establish a vitally needed capital markets group, to pursue Commission initiatives arising out of the October 1987 market crash, and to address regulatory issues in the market for municipal securities. In addition, the Commission's broker-dealer examination staff will need additional resources to ensure that it can continue to detect abusive sales and trading practices.

The mission of the Commission's Full Disclosure program is to provide investors with material information and to prevent

fraud and misrepresentation in the public offering, trading, voting, and tendering of securities. The Commission's disclosure staff reviews disclosure filings from approximately 14,000 public companies. From 1980 to 1988, there was a 135% increase in the number of registration statements filed, and a 175% increase in the number of merger proxies filed. The transactions and securities under review have also become more novel and complex. This program will require additional resources over the next several years to permit it to provide adequate review of disclosure filings, to continue its review of leveraged buyouts and other takeover activities, and to respond to market developments. In addition, the Commission will require additional resources to continue its implementation of its electronic filing system for disclosure documents. If the Administration's proposal to subject publicly-issued bank and thrift securities to Commission regulation is adopted, the Division of Corporation Finance will need additional staff to administer those requirements of the federal securities laws applicable to banks and savings and loans.

The Investment Management Program seeks to minimize the risk of investor loss through the review of disclosure, regulation, and inspection of investment companies and investment advisers. This program also seeks to ensure that public utility holding companies operate in the public interest and have sound financial structures. From the end of fiscal year 1980 through fiscal year 1989, the number of registered investment companies increased by an estimated 146%, while the number of registered investment advisers increased an estimated 217%. However, the Commission's examination staff has not increased significantly since 1980. The Commission needs additional resources to devote to this program to provide adequate levels of inspection and regulation of investment companies and advisers, as well as to meet the significant challenges presented by industry growth, more diverse financial products, and greater internationalization of the financial markets.

In addition to requiring adequate resources for these four programs, the Commission also must have access to high quality legal services, provided by the Commission's Office of the General Counsel. This Office represents the Commission in all appellate litigation, including litigation where the Commission appears as amicus curiae. The Office is also responsible for defending the Commission in suits challenging the Commission's rulemaking and administrative orders and enforcement authority, and for prosecuting certain disciplinary proceedings against professionals who practice before the Commission. Additionally, the Office provides a variety of legal advisory services to the Commission, responds to Congressional inquiries, and assists Congress in the drafting of legislation. The increased level of Commission enforcement and legislative activity will continue to place additional burdens on the Office's staff. The Office will

need additional resources in the next three years in order to ensure that it can meet these challenges in the legal and legislative areas.

The Commission has been actively addressing concerns raised by the increasing internationalization of the securities markets. In March of this year, the Commission submitted a legislative proposal to Congress that would enhance international cooperation in the enforcement of the securities laws. The Commission also has proposed Regulation S, which is intended to clarify the extraterritorial application of the registration provisions of the Securities Act, and Rule 144A, which would provide a safe harbor from the Securities Act registration requirements for specified offers, sales, and resales of securities to institutional investors. The Commission's staff is also developing an initial multi-jurisdictional registration experiment with Canada. These and other Commission initiatives designed to address the internationalization of the world's securities markets will continue to require substantial staff resources.

In each of the last six fiscal years, due largely to increased market activity, registration, transfer, and other fees received by the Commission have significantly exceeded the Commission's budget. In its recent Self-Funding Study, the Commission's staff found that the agency needs special new authorities in order to attract and retain quality staff, and developed five specific recommendations to accomplish this goal.

II. THE COMMISSION'S ENFORCEMENT PROGRAM

A. Workload

The Commission has authority under the federal securities laws to investigate possible securities law violations and, when unlawful conduct is discovered, to bring enforcement actions in federal court, to institute administrative proceedings, or to refer matters to the United States Department of Justice for criminal prosecution. The Commission continues to exercise vigorously its authority to enforce the securities laws. Increases in workload without sufficient increases in Commission resources could, however, hamper the Commission's enforcement efforts. In fact, a limitation in Commission resources was one of several factors the Commission considered when it recently decided not to initiate its own enforcement action in the Washington Public Power Supply System matter.

In 1987, the Commission received over 40,000 complaints and inquiries from investors, over 230% the number received in 1982. The National Association of Securities Dealers reported receiving over 5,000 additional complaints, approximately 340% more than the number it received in 1982. In 1988, the Commission experienced an additional 22% increase in the number of investor

complaints and inquiries, with a total number of 49,000 received that year. Moreover, as discussed below, the Commission's enforcement investigations and litigation have become increasingly complex and thus necessitate a greater expenditure of staff resources.

B. The Effect of Complex Litigation

The Commission's enforcement program is comprehensive and includes cases involving fraudulent securities offerings, corporate reporting and accounting violations, violations by broker-dealers and other regulated entities, insider trading, and market manipulation.

In recent years, the nature of the Commission's investigations and litigation has become increasingly complex. Two recent cases that exemplify this increased complexity are SEC v. Drexel Burnham Lambert Incorporated, et al., No. 88 Civ. 6209 (S.D.N.Y. filed Sept. 7, 1988) and SEC v. Stephen Sui-Kuan Wang Jr., and Fred C. Lee, a/k/a Chwan Hong Lee, No. 88 Civ. 4461 (S.D.N.Y. filed June 27, 1988). Drexel Burnham is an injunctive action in which the Commission alleges that the investment banking firm, the head of its high yield and convertible bond department, and others devised and carried out a scheme involving fraud, insider trading, stock manipulation, nondisclosure of required information concerning the beneficial ownership of securities, and numerous other securities law violations. The action illustrates the increasingly detailed, complex, and litigious aspects of the Commission's determination to pursue fraudulent activities of securities professionals. The complaint alleges that at least sixteen series of illegal transactions resulted from a secret arrangement with Ivan Boesky, who was enjoined and barred from the securities business by the Commission in November 1986 and agreed to pay as settlement $100 million in disgorgement and penalties. The complaint further alleges that in at least two transactions not involving Boesky, Drexel and its official traded while in possession of material nonpublic information obtained through misappropriation or in breach of a fiduciary duty owed to Drexel's clients. With the Commission's assistance, the U.S. Attorney for the Southern District of New York has brought a related criminal action against Drexel. Drexel has tentatively agreed to pay $650 million in fines and disgorgement as part of the resolution of that matter. The Commission has devoted more than 35 staff years to this matter, while Drexel and the other defendants are reported to have expended tens of millions of dollars in the case.

SEC v. Wang and Lee reflects the complexities arising from the internationalization of the securities markets. In Wang, the Commission alleged that an analyst in the mergers and acquisitions department of a major investment banking firm illicitly provided information concerning proposed mergers and other

extraordinary transactions involving the firm's clients to a Taiwanese investor residing in Hong Kong. While in possession of this information, the investor allegedly directed the purchase and sale of securities of at least 25 issuers through various accounts, realizing at least $19 million in illegal profits. The Commission obtained a temporary restraining order from the federal district court in Manhattan, including a freeze of all assets belonging to the investor, the companies he controlled, and his trading nominees. The freeze order extended to a bank with branch offices in both New York and Hong Kong. Following entry of the order, the investor attempted unsuccessfully to retrieve funds from the Hong Kong branch of the bank. At the Commission's request, the court ordered the defendants not to seek further relief from the previous order in either foreign or United States courts, and to pay over $12 million from the bank's account into the registry of the court. This aspect of the case is still being litigated. The analyst, whose alleged benefit from the trading scheme was estimated at $200,000, pleaded guilty to criminal charges, and was sentenced to a three-year prison term, to be followed by three years of probation.

Complex cases such as Drexel Burnham and Wang require greater staff resources than do routine securities fraud cases. Moreover, because of the substantial sums of money at stake in these kinds of cases, defendants are more likely to engage in protracted litigation with the Commission. It is imperative that, in order to maintain justified investor confidence in the integrity of the U.S. securities markets, the Commission continue to bring such cases when it believes that unlawful conduct has occurred. The Commission also will continue to work with Congress, the other enforcement agencies, and foreign regulatory agencies, to facilitate increasingly complicated securities law investigations and enforcement actions.

As the number of complicated matters pursued by the Commission increases, it becomes increasingly difficult to find resources to pursue more routine but nevertheless important enforcement matters. Without additional resources, the Commission may be forced to forego some major enforcement actions in order to preserve a good balance in the Commission's enforcement program. For example, in 1983, the Washington Public Power Supply System ("Supply System") defaulted on $2.25 billion in principal of tax-exempt bonds sold to finance the construction of two nuclear power plants. The default on the bonds was the largest payment default in the history of the municipal bond market. The staff's investigation 1/ revealed serious concerns as to whether the official statements for the Supply System's

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1/ Securities and Exchange Commission Staff Report on the Investigation in the Matter of Transactions in Washington Public Power Supply System Securities (1988).

bonds adequately disclosed significant factors and as to the conduct of various professionals involved. However, the Commission determined not to pursue the matter, in part due to concern as to the level of resources necessary to litigate the case.

C. Prevention of Fraud in the Penny Stock Market

The Commission is mobilizing its efforts to protect small investors from penny stock fraud and manipulation. "Penny stocks" are low-priced, over-the-counter securities that sometimes are quoted in the National Association of Securities Dealers' Automated Quotation System ("NASDAQ"), 2/ but usually are quoted in a medium such as the National Quotation Bureau's "pink sheets." 3/ Because these stocks generally are thinly-traded and may be subject to domination and control by a single market maker, they can be an attractive vehicle for manipulation and fraud.

The Division of Market Regulation's broker-dealer examination program and the Division of Enforcement's investigations have revealed serious problems of fraud and manipulation in the market for penny stocks. In the summer of 1988, the Commission's broker-dealer examination program undertook a special sweep of examinations targeted at penny stock firms. Of the 17 initial examinations, 14 resulted in enforcement referrals. The Commission's broker-dealer examination program will continue to target penny stock firms over the next several years.

In response to the problem of penny stock fraud, the Commission organized a Task Force on Penny Stock Manipulation. The purpose of the Task Force is to identify the problems posed by penny stock manipulation, to consider regulatory solutions to those problems, and to consider how to educate investors regarding the dangers of penny stock fraud. The Task Force also

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2/ Volume and price information with respect to exchange listed or NASDAQ quoted stocks is collected electronically and continually published so that investors can determine recent volume and price movement. Price and volume information with respect to penny stocks normally is not collected automatically and made readily available to the public. Brokerage firms trading a penny stock can usually provide information only about trades they make.

3/ The "pink sheets" are a daily publication that reflects market maker interest in thousands of over-the-counter stocks, including penny stocks. The market makers may publish bid and ask quotations for specific securities or simply advertise their general interest in receiving bids or offers for specific securities.

seeks to improve coordination and information-sharing with other law enforcement agencies in order to strengthen the Commission's regulatory and enforcement programs. The Commission is holding regional meetings around the country with regulatory and law enforcement officials from state and federal agencies to facilitate more vigorous civil and criminal prosecution of penny stock frauds. The Commission is also preparing a training program on penny stock fraud for U.S. Attorneys, the Federal Bureau of Investigation, the U.S. Customs Service, the U.S. Postal Inspection Service, the Internal Revenue Service/Criminal Investigation Division, state authorities, and international law enforcement officials. The training program will be held this summer.

The Commission has accelerated its enforcement efforts against individuals involved in a wide array of misconduct in connection with the penny stock market. In 1988, the Commission initiated more than 25 enforcement actions involving fraud or abuse in the penny stock market, and suspended over-the-counter trading in more than 100 penny stocks.

In addition, the Commission has been increasingly involved in joint investigations of fraudulent penny stock schemes with other law enforcement agencies. Of particular interest is the recent thirty-six count indictment announced in Salt Lake City on January 18, 1989, relating to manipulation in the securities of Protecto Industries. This indictment involved the joint efforts of the U.S. Attorney for the State of Utah, the FBI, and the Commission's Salt Lake City and Denver offices. The Commission's Miami Branch Office has organized a Florida Penny Stock Task Force that includes representatives of the IRS, the FBI, state securities authorities, and the U.S. Attorney. Policing market manipulation in the penny stock market is critical to continued investor confidence.

Many fraudulent and manipulative schemes depend on the abusive sales tactics of certain broker-dealers, such as high pressure cold calls. To address these abuses, the Commission has proposed Exchange Act Rule 15c2-6, 4/ which would require broker-dealers, prior to the sale of certain pink sheet securities to persons who are not regular customers, to obtain a written customer agreement to the sale, and to make a written determination that the security is a suitable investment for the customer. The Commission is also formulating other regulatory initiatives to address manipulation schemes in the penny stock area.

4/ Securities Exchange Act Release No. 26529 (February 8, 1989), 54 Fed. Reg. 6693 (1989).

In addition, to promote investor education, the Task Force has written and distributed a flyer that sets forth basic information about penny stocks, discusses warning signs of penny stock fraud, and recommends certain measures to take before investing in penny stocks. There has been a significant amount of publicity directed to penny stock fraud in the last several months and the Commission is actively seeking to continue publicizing the risks to investors from fraudulent penny stock schemes.

D. Enforcement Efforts Involving Fraud Connected with Banks and Savings and Loans

In recent years, the Commission has brought a number of enforcement actions alleging reporting and other securities law violations by banks, savings and loan associations, and their holding companies and associated persons. The Commission cooperates with bank and savings and loan regulators in these investigations. For instance, the Commission's staff obtains information and documents from bank and savings and loan regulators regarding their examination of the financial institutions under investigation. Moreover, the Commission, upon request, routinely grants the banking authorities access to its non-public investigative files.

The Commission uses this information to enforce vigorously the securities laws in matters involving inadequate loan loss reserves, related party transactions, and other improper activities by financial institutions and related persons. For example, in SEC v. Financial Corporation of America, No. 87 Civ. 2578 (D.C. Cir. filed Sept. 21, 1987), the Commission sought permanent injunctive and other equitable relief against a savings and loan holding company, alleging that the holding company had violated the reporting, books and records, and internal controls provisions of the federal securities laws. Without admitting or denying the Commission's allegations, the holding company consented to the entry of a permanent injunction and other equitable relief. In In the Matter of American Savings and Loan Association of Florida, 5/ the Commission and the Federal Home Loan Bank Board (the "FHLBB") issued a report of investigation and order pursuant to Sections 15(c)(4) and 21(a) of the Exchange Act and Section 407(e) of the National Housing Act with respect to American Savings and Loan Association of Florida ("ASLA"), a Florida savings and loan association. The report stated that ASLA violated the reporting provisions of the federal securities laws by failing to disclose in its press releases, in reports filed with the FHLBB, and in shareholder reports material information related to certain repurchase

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5/ Securities Exchange Act Release No. 34-25788 (June 8, 1988).

transactions. The order required ASLA to comply with certain disclosure provisions of the Exchange Act and to comply with its undertaking to require outside securities counsel to review and approve its FHLBB disclosure filings and certain of its press releases. ASLA consented to the report and order, without admitting or denying any of the allegations.

The Commission also brought an administrative proceeding against the holding company of Continental Illinois National Bank and Trust Co. of Chicago. 6/ The Commission alleged that Continental mischaracterized a substantial portion of the loan loss provision reported in its quarterly report for the second quarter of 1984. Continental consented to a Commission order directing it, among other things, to comply with various provisions of the Exchange Act, and to restate its financial statements. In In the Matter of Texas Commerce Bancshares, Inc., 7/ the Commission found that Texas Commerce Bancshares, Inc. ("TCB"), a bank holding company, had failed to have in place an adequate loan loss review system, and that as a result, the consolidated loan loss reserve for TCB, as of December 31, 1984, was understated by $28.2 million. TCB consented to the issuance of an order requiring it to comply with the reporting, books and records, and internal controls provisions of the Exchange Act, and to comply with certain undertakings.

E. Proposed Securities Law Enforcement Remedies

On January 18, 1989, the Commission submitted to Congress a legislative proposal to amend the securities laws to authorize new types of enforcement remedies. This bill has been introduced in the Senate as S. 647 by Chairman Dodd and Senator Heinz, and in the House of Representatives by Congressman Dingell as H.R. 975.

The amendments would authorize the Commission to request that federal courts impose civil monetary penalties for violations of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. The Commission also would be authorized to impose civil penalties of up to $100,000 per violation by individuals and up to $500,000 per violation by others in certain administrative proceedings under the Exchange Act, the Investment Company Act, and the Investment Advisers Act. The proposal would also expressly authorize a court to suspend or bar a violator of the federal securities laws from service as an officer or

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6/ In the Matter of Continental Illinois Corporation, Accounting and Auditing Enforcement Release No. 128 (Feb. 27, 1987).

7/ Accounting and Auditing Enforcement Release No. 146 (Aug. 17, 1987).

director of any reporting company, and would provide the Commission with similar authority in proceedings under Section 15(c)(4) of the Exchange Act. Finally, the proposal would add violations of Section 16(a) of the Exchange Act as bases for administrative proceedings under Section 15(c)(4) of that Act. Section 16(a) imposes stock ownership reporting requirements on persons owning more than ten percent of any class of equity security registered pursuant to Section 12 of the Exchange Act and on officers and directors of issuers of such securities. The amendment to Section 15(c)(4) would provide the Commission with an administrative remedy to address Section 16(a) reporting violations that may not warrant an injunctive action. Expansion of remedies such as those contained in this bill and in the recently enacted Insider Trading and Securities Fraud Enforcement Act of 1988 will create additional need for increases in enforcement staff and support budgets because defendants and respondents may be more likely to litigate.

III. MARKET REGULATION

A. Workload

In recent years, there has been an explosive growth in the number of broker-dealer firms. From 1980 through 1989, there was an estimated 88% increase in the number of registered broker-dealer firms, from 6,750 to 12,700, and an estimated 145% increase in the number of registered representatives, from 196,000 to 480,000. During the same period, the Division of Market Regulation's staff years actually declined, from 268 to 244. Adequate supervision of the financial services industry is essential for the protection of investors and for the maintenance of investor confidence in our nation's capital markets. The Commission needs additional resources to ensure that the Division can perform its supervisory and related functions in the face of these dramatic increases in its workload. The Commission's broker-dealer examination staff will also need additional resources to ensure that it can continue to detect abusive sales and trading practices. In particular, increased examination staff is needed to increase the number and scope of cause examinations of firms engaged in blank check offerings and in the secondary trading of penny stocks; to conduct more extensive reviews of firms' retail pricing practices and in-depth assessments of their "Chinese Wall" procedures; and to enhance the analyses of customer accounts to detect excessive trading and churning. In addition, as contemplated by recent changes to the Exchange Act, the increased examination resources are needed to ensure that broker-dealers maintain appropriate supervisory procedures to prevent insider trading.

At the Commission's urging, the self-regulatory organizations ("SROs") have been devoting greater resources to their supervisory responsibilities. In recent years, there has been a

significant increase in the size of the self-regulatory organizations' staffs. The four largest SROs (in terms of regulatory staffing) are the New York Stock Exchange, the American Stock Exchange, the Chicago Board Options Exchange, and the National Association of Securities Dealers. From 1985 to 1989, the number of staff persons devoted to surveillance, examinations, enforcement, and general regulatory programs at these SROs increased approximately 32%, from a total of approximately 1,254 persons to approximately 1,654 persons. During this period, the number of staff persons devoted to these programs increased 47% at the New York Stock Exchange, 32% at the National Association of Securities Dealers, 17% at the American Stock Exchange, and 8% at the Chicago Board Options Exchange.

This increase in SRO resources has enhanced the SROs' ability to detect suspicious sales and trading activities, and to enforce their rules against member firms and associated persons. While this increase in SRO activity has complemented the Commission's enforcement efforts, there is still a need for increased Commission enforcement resources. Large components of the Commission's enforcement program, such as cases involving financial disclosure or accounting, cases involving investment companies and investment advisers, and most cases involving fraudulent securities offerings, are unaffected by the increase in SRO activity. Moreover, even in the broker-dealer area, the jurisdiction of the SROs is limited to member firms and their associated persons. For example, an SRO may proceed against a broker-dealer or a registered salesperson involved in insider trading, but not against a customer involved in the same activity. Accordingly, the continued high level of referrals from the SROs necessitates additional Commission resources to ensure that the agency can investigate and, when appropriate, bring enforcement actions with respect to these referred matters.

B. Proposed Capital Markets Unit

The extraordinary changes to the securities markets during the past decade have profoundly influenced the broker-dealer business. Today, many broker-dealer firms concentrate a substantial amount of their capital in complex trading strategies involving securities, futures, currencies, and interest-rate swap vehicles. Moreover, the major firms now generally conduct business as part of a larger holding company complex that includes numerous unregulated affiliates.

These complex trading strategies and the activities of the unregulated affiliates could expose firms to increased risk of failure that could cause a significant disruption of the financial markets. Accordingly, it is essential that the Commission's staff be able to assess the extent to which broker-dealer firms are exposed to market, credit, and other risks associated with an increasingly global mix of business activities. The Division of

Market Regulation thus has proposed the creation of a capital markets unit to monitor the risk exposure of major securities firms and their unregulated affiliates. This unit would permit the Commission better to anticipate where a significant risk to the U.S. financial markets or U.S. customers might arise and to increase the ability of firms and self-regulatory organizations, as well as of U.S. and foreign government agencies, to address risk. The unit would also be designed to foster increased cooperation and information sharing among international banking and securities supervisory agencies.

C. Commission Recommendations Regarding the October 1987 Market Break

In October 1987, the nation's securities and stock index futures markets underwent an extraordinary surge of volume and price volatility, culminating in a steep and abrupt decline on October 19 and 20, 1987. The Division of Market Regulation prepared a comprehensive study of these events. The staff's report found that no single factor -- economic, structural, or psychological -- was responsible for the size and breadth of the market break. It concluded that rapid, large stock and futures sales by institutions, while not the sole cause of the market break, were significant factors in accelerating and exacerbating a decline triggered by changes in investor perceptions regarding investment fundamentals and economic conditions.

In June and July 1988, the Commission submitted to Congress a series of legislative proposals to address issues raised by the October market break. The Commission's legislative proposals included the following areas of particular concern:

First, the Commission concluded that uncertainty about the total risk exposure of participants in the stock, options, and futures markets exacerbated conditions during the market break. It therefore recommended that it be authorized to establish reporting requirements for registered broker-dealers regarding the activities of their affiliates that are likely to have an impact on their financial or operational condition.

Second, the Commission determined that SRO surveillance and trade reconstruction efforts would be enhanced by the development of information systems for large stock transactions. It therefore recommended legislation to require reporting of such transactions. This authority would enable the Commission to create a reporting system that would increase its ability to identify and monitor activities that are likely to affect the equities markets.

Third, the Commission concluded that it was imperative to move to a more coordinated credit, clearance, and settlement system across markets. Accordingly, it recommended legislation

specifically directing the Commission and the Commodity Futures Trading Commission to facilitate the goal of integrated cross-market clearance and settlement systems.

Fourth, the Commission proposed that it be granted authority to take a number of different kinds of actions to respond to market emergencies. This authority, similar to that currently held by the CFTC, would, among other things, enable the Commission to make margin changes, delay openings, close markets early, and temporarily halt trading.

Chairman Dodd and Senator Heinz have introduced these four legislative proposals in the 101st Congress as S. 648, and Congressman Dingell has introduced them as H.R. 1609.

D. Municipal Bond Disclosure

The Commission is concerned about the current quality of disclosure in certain municipal bond offerings, especially in light of changes in the market for municipal securities. At the time the securities laws first were enacted in 1933, most municipal securities offerings involved general obligation bonds that were primarily sold to institutions within a limited geographic area. Since 1933, however, the municipal markets have become national and now include a broader range of investors. In addition, municipal financings have become increasingly complex, with a greater proportion of revenue bonds that may pose greater credit risks to investors because they are not backed by the full faith and credit of a governmental entity. Further, more innovative forms of financing have focused increased attention on call provisions and redemptive rights.

The preparation and timely dissemination of official statements, in conjunction with a careful review of the issuer's disclosure by the underwriters, are important disciplines that benefit the participants as well as investors. In addition, with the increase in novel or complex financings, there may be greater value in having investors receive disclosure documents describing fundamental aspects of their investment. Underwriters are unable to perform this function effectively when offering statements are not provided to them on a timely basis. Moreover, where sufficient quantities of offering statements are not available, underwriters are hindered in meeting present delivery obligations imposed on them by rules of the Municipal Securities Rulemaking Board ("MSRB").

For these reasons, on September 22, 1988, the Commission proposed Rule 15c2-12, 8/ which would require that underwriters

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8/ Securities Exchange Act Release No. 26100 (Sept. 22, 1988), 53 Fed. Reg. 37778 (1988).

of municipal securities offerings exceeding $10 million obtain and review a nearly final official statement before bidding on or purchasing the offering. The rule also would require underwriters of a municipal offering exceeding $10 million to contract with the issuer or its agents to obtain final official statements in sufficient quantities to permit delivery to investors in accordance with MSRB requirements and, depending on the time of the request, to make available a single copy of the preliminary and final official statement to any person on request. In addition, the Commission published an interpretive statement emphasizing the responsibility of municipal underwriters to have a reasonable basis for believing in the substantial accuracy of key representations contained in the official statement, as well as any other recommendations that they make regarding the offering.

If this rule is adopted, the Commission will have greater inspection and enforcement obligations in the municipal securities field, requiring additional resources.

IV. FULL DISCLOSURE

A. Workload

The number of disclosure filings received by the Commission has grown substantially. From 1980 to 1988, there has been a 135% increase in the number of registration statements filed each year under the Securities Act, from 710 to 1,671, and a 175% increase in the number of merger proxies filed, from 140 to 385. During the same period, filed tender offer schedules increased 663%, from 104 to 794, and filed annual reports have increased 37%, from 8,344 to 11,443. Further, transactions and securities under review have become more novel and complex, and often raise difficult legal, financial, and accounting issues. The internationalization of the world's securities markets also has created many issues for the Commission's disclosure staff. This increase in the complexity of the staff's activities, as well as the dramatic increase in disclosure filings, necessitate additional staff resources.

B. Leveraged Buyouts

The Commission is currently devoting significant attention to leveraged buyouts ("LBOs") and other takeover activities. In an LBO, assets of the subject company are used as collateral for a loan that is obtained to pay all or part of the purchase price of the company or to accomplish a restructuring of the

company. 9/ The federal securities laws are designed to provide the subject company's shareholders with information concerning the transaction in which they are asked to sell their securities. The disclosure concerns generated by highly leveraged transactions, however, reach beyond the interests of the subject company's shareholders and affect holders of senior debt securities, purchasers of the debt securities issued to finance the transaction, and equity participants in the surviving entity. The Division of Corporation Finance is exploring possible rulemaking and interpretive initiatives to ensure that investors receive adequate information. In addition, investment vehicles that allow small investors to participate in these transactions indirectly and on a diversified basis through so-called "junk bond" 10/ funds and business development companies formed to invest in LBO securities, or through employee stock ownership plans, may raise significant disclosure and, in the case of funds, inspection concerns. Further, the potential effect on banks, thrifts, insurance companies, broker-dealers, and investment banking firms that may finance these transactions must be considered.

Management-led leveraged buyouts ("MBOs") raise particular policy concerns. In an MBO, management, either alone or, more typically, in conjunction with a group of outside investors (usually an LBO firm), acquires the company from its public stockholders in a going-private transaction. 11/ Management can have an inherent informational advantage over nonaffiliated shareholders and is presented with a conflict of interest when dealing with the corporation's shareholders. The Commission has adopted an extensive and detailed disclosure system to address these issues and is currently monitoring its effectiveness. In addition, state law has developed substantive and procedural protections for shareholders against conflicts of interest in these transactions. The Commission's staff will be exploring proposals to expand or modify the scope of current rules to

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9/ See Leveraged Buyouts and the Pot of Gold: Trends, Public Policy, and Case Studies, A Report Prepared by the Economics Div. of the Congressional Research Service for the House Subcomm. on Oversight and Investigations of the Comm. on Energy and Commerce, 100th Cong., 2d Sess. (Dec. 1987) (Comm. Print No. 100-R).

10/ The term "junk bond" refers to high-yield, non-investment grade bonds. Because they carry more risk, junk bonds, which are also sometimes referred to as "high yield bonds," must pay a higher rate of interest to attract investors.

11/ A "going private transaction" is a transaction by the issuer or affiliates which results in the elimination of public ownership of a class of equity securities.

assure that they address current market practice, and will continue to monitor state law developments.

The Commission's Office of Economic Analysis ("OEA") and Division of Corporation Finance are gathering data on, and analyzing, the LBO phenomenon in order that Congress and the Commission may assess the policy implications of these transactions. In response to a January 6, 1989 request from the Senate Banking Committee, OEA has collected data describing 142 leveraged buyouts during 1984-1988 that had transaction values of at least $100 million. The Division and OEA are examining, among other things: (1) the adequacy of disclosure in these transactions; (2) the sources of financing; (3) the effects of the transactions on stock and bond prices, profits, cash flow, effective taxes, asset sales, employment and wages, research and development, and capital expenditures; (4) management participation in these transactions; (5) fee structures; and (6) the returns obtained in "reverse LBO" transactions in which a company that had been taken private seeks to become publicly-held again. The results of these efforts will be presented to Congress and will provide the basis for discussion of potential Commission initiatives.

C. Status of EDGAR

The Commission is moving ahead with its development of a fully operational EDGAR (Electronic Data Gathering, Analysis, and Retrieval) system. EDGAR is the Commission's program that enables registrants to file documents with the Commission electronically, via a computer link. Implementation of operational EDGAR will accelerate dramatically the filing, processing, dissemination, and analysis of time-sensitive information filed with the Commission. Under EDGAR, when information is electronically filed with the Commission it will be accessible to investors, the media, and others on personal and business computer screens in minutes, instead of days and weeks.

On January 3, 1989, the Commission awarded the EDGAR contract to the BDM Corporation, with Mead Data Central, Inc., Sorg Incorporated, and Bechtel Information Services as subcontractors. The contract has an expected term of eight years. The initial three years will be on a cost reimbursement plus fixed fee basis; the last five years will be on a fixed price basis. Phase-in of filers will begin in mid-1990 and is expected to be completed in 1993.

The North American Securities Administrators Association ("NASAA") has indicated that state securities regulators want the same direct, on-line linkage to the EDGAR system that the Commission examiners will have. The Commission has offered to provide NASAA a direct feed of state-related electronic filings which NASAA could distribute to the states via their own

computer facility. If the states were given the direct access they request, there would be additional costs to the Commission associated with this link. The magnitude of these costs is uncertain at this point.

Currently in its fourth year of operation, the EDGAR pilot program has demonstrated the feasibility of electronic filing and review procedures. More than 40,000 electronic filings were made between September 1984 and the 1988 fiscal year end.

D. Regulation of Banks and Savings and Loans

As part of its plan to reorganize the savings and loan industry, the Administration has proposed that all securities issued by banks and thrifts to the investing public, with the exception of deposit instruments, be made subject to the registration requirements of the Securities Act, and that administration and enforcement of disclosure requirements with respect to such entities be transferred to the Commission. These proposals are substantially similar to the recommendation of the Bush Task Group on Regulation of Financial Services that the securities registration and reporting requirements of all publicly-owned banks and thrifts be transferred to the Commission. If this proposal is adopted, the Division of Corporation Finance will need additional staff to administer those requirements for banks and savings and loans.

E. Legislative Initiatives

On March 17, 1989, Chairman Dodd and Senator Heinz introduced as S. 651 the Trust Indenture Reform Act of 1989, which was first proposed by the Commission in November 1987. Congressman Rinaldo introduced this bill in the House as H.R. 1786 on April 11, 1989. This legislation would modernize the Trust Indenture Act of 1939, which regulates the public issuance of debt securities and the relationships among security holders, indenture trustees, and obligors. The legislation also would broaden the Commission's exemptive power to allow for variation from the Act's requirements in appropriate circumstances. In recognition of the character of an indenture trustee's legal duties and the realities of trust practice, the bill would make technical conflicts of interest irrelevant to a trustee's eligibility prior to default. To promote the internationalization of public securities markets, the bill would also permit the Commission to allow foreign trustees under qualified indentures in certain circumstances.

The Commission has also supported legislation to reduce the period for filing an initial beneficial ownership report under Section 13(d) of the Exchange Act from ten days to five business days and to prohibit the filing person from acquiring additional securities until the required filing is made with the

Commission. 12/

V. INVESTMENT MANAGEMENT REGULATION

A. Increase in Regulated Entities

In recent years, there has been a tremendous growth in the number of investment companies and investment advisers and in the assets they manage. From the end of fiscal year 1980 through fiscal year 1989 the percentage increase in the number of registered investment companies is estimated to be 146% (from 1,461 to 3,600), while the percentage increase in the number of registered investment advisers is estimated to be 217% (from 4,580 to 14,500).

Despite this industry growth, the Commission's examination staff has not significantly increased since 1980 because of budgetary constraints. This has resulted in a decline in the percentage of registrants inspected. The average inspection period for investment companies during 1989 is expected to be once every 4.7 years, and, even assuming anticipated staff increases in 1990, the average inspection period is expected to be once every 4.2 years. The Commission's inspections of investment advisers now occur, on the average, once every 12 years and should only improve to 11.1 years if the staff increases contained in the 1990 budget request are forthcoming.

The Commission's investment management program also faces a number of challenges presented by industry growth, more diverse financial products, and greater internationalization. Investment companies and investment advisers invest in numerous complex financial products, such as interest-only and principal-only portions of debt securities, foreign currency forwards, Euro-bond options, limited partnerships, and securities backed by credit card receivables, car loans, and other assets. The examination of such complex products requires highly skilled examiners and specialized inspection techniques. Moreover, some investment companies regulated by the Commission invest in foreign portfolio securities, have foreign advisers or subadvisers, and keep custody of securities overseas. The practical problems associated with regulating these entities require that the Commission enter into cooperative arrangements with foreign regulators to conduct joint compliance examinations.

12/ See Statement of David S. Ruder, Chairman of the Securities and Exchange Commission, Before the House Subcommittee on Telecommunications and Finance, September 17, 1987; Statement of Charles C. Cox, Acting Chairman of the Securities and Exchange Commission, Before the Senate Committee on Banking, Housing, and Urban Affairs, June 23, 1987.

In addition, these and other new products, internationalization, and other market developments have required the Commission staff to consider many more and increasingly complex requests for exemptive relief from the stringent requirements of the Investment Company Act.

B. Public Utility Holding Company Act

Due to budgetary constraints, the Commission's staff is having difficulty meeting its responsibilities on a timely basis under the Public Utility Holding Company Act of 1935. The staff is responsible for reviewing filings made under the 1935 Act and for acting on applications for exemptive relief. The types of complex issues that the staff is analyzing and anticipates continuing to review in the foreseeable future include sales and leasebacks of utility assets in amounts that may individually exceed one billion dollars, creation of holding companies in order to facilitate diversification, nonconventional financings by utility companies in order to fund existing nuclear utility projects, increased diversification by registered holding companies into nontraditional utility areas, involvement in cogeneration and independent power production projects in order to compete with non-1935 Act regulated businesses, and accounting standards and practices that conflict or may conflict with those of the Federal Energy Regulatory Commission. Recently, many of the largest public utility holding company systems in the United States have expressed their desire for prompter response by the staff to exemptive and rulemaking requests. Without increased appropriations, however, it will not be possible to eliminate significant existing backlogs in exemptive and rulemaking requests.

C. Shareholder Communications Improvement Act of 1989

On March 17, 1989, Chairman Dodd and Senator Heinz introduced in the Senate the "Shareholder Communications Improvement Act of 1989" as S. 649. This legislation would extend the benefits of the Commission's shareholder communication rules to investment company beneficial security holders. These rules now require brokers and dealers, banks, associations, and other entities that exercise fiduciary powers holding securities in nominee name to deliver proxies, consents, and authorizations to the beneficial owners and to supply registrants, upon request, with beneficial owner information so that registrants can send annual reports and voluntary communications directly to beneficial owners. S. 649 would also require that registered investment companies provide information statements to security holders in connection with meetings of security holders if management is not soliciting proxies, consents, or authorizations. The bill would also provide that nominees must deliver information statements to beneficial owners of investment

company securities and securities registered under Section 12 of the Exchange Act.

VI. LEGAL SERVICES

The increased level of Commission enforcement activity, particularly in the insider trading, financial fraud, and broker-dealer regulation areas, has generated a heavy caseload for the Office of the General Counsel. This Office reviews proposed enforcement actions to ensure policy consistency, adherence to recent court developments, and appropriate resolution of novel legal issues. The General Counsel also represents the Commission in the appellate courts when decisions in judicial or administrative enforcement proceedings are appealed, and litigates disciplinary actions against attorneys and accountants under Rule 2(e) of the Commission's Rules of Practice. Each of these activities increases as the level of activity in the Commission's enforcement program increases.

With respect to appellate litigation, the Office represents the Commission both in appeals involving Commission enforcement cases and as amicus curiae in private actions raising significant issues under the federal securities laws. In fiscal year 1988, the Supreme Court considered three important cases in which the Office filed briefs. In United States v. Carpenter, 108 S. Ct. 316 (1987), the Supreme Court affirmed by an equally divided court the Second Circuit's adoption of the Commission's misappropriation theory of liability in an insider trading case. In Basic, Inc. v. Levinson, 108 S. Ct. 978 (1988), the Supreme Court adopted the Commission's positions that preliminary merger negotiations are, under some circumstances, material, and that an investor-plaintiff may show reliance under the fraud-on-the-market theory. In Pinter v. Dahl, 108 S. Ct. 2063 (1988), the Supreme Court adopted the Commission's position as to the availability and scope of the common law in pari delicto (equal fault) defense in actions by investors under Section 12(1) of the Securities Act of 1933 for rescission of the sale of unregistered securities. The Court also largely adopted the Commission's position as to who can be liable as a "seller" under Section 12(1).

Court of appeals litigation arising from Commission enforcement actions requires the Office to brief an extraordinarily wide range of issues, as defendants in Commission litigation exhibit an increasing propensity to assert novel theories. For example, this Office successfully represented the Commission in a circuit court case challenging the Commission's authority to bring civil enforcement actions. Blinder Robinson & Co., Inc. v. SEC, 855 F.2d 677 (10th Cir. 1988), cert. denied, 57 U.S.L.W. 3552 (Feb. 21, 1989). The Office also recently represented the Commission in its successful opposition to a petition for a writ of mandamus, which was filed by certain defendants in SEC v. Drexel

Burnham Lambert Inc., et al., No. 88 Civ. 6209 (S.D.N.Y. filed Sept. 7, 1988). The petition had urged that the Court of Appeals for the Second Circuit order the district judge to recuse himself from the case.

In addition, the Office litigates the Commission's disciplinary proceedings against professionals, including attorneys and accountants, under Commission Rule 2(e). Recently, the Commission has increased the number of these proceedings, which are complex, fact-intensive, and typically involve multiple respondents and issues, expert witnesses, and computerization of a large number of documents. For example, one important case prosecuted by the Office is In the Matter of John M. Schulzetenberg, C.P.A 13/, in which, after presentation of the staff's case-in-chief, the respondent consented, without admitting or denying the Commission's allegations, to a Commission opinion and order finding that he had engaged in improper professional conduct as an auditor. The Commission's opinion sets forth its views of the obligations of an auditing firm's engagement partner to adequately plan and supervise an audit. An increased number of financial fraud investigations by the Division of Enforcement has correspondingly increased the number of these disciplinary proceedings against accountants.

The Office's Adjudication Group is responsible for preparing the Commission's opinions in its administrative enforcement proceedings (other than those under Commission Rule 2(e)) and in appeals from self-regulatory organization disciplinary actions. Two particularly significant administrative opinions of fiscal year 1988 were In the Matter of Adrian Antoniu, Securities Exchange Act Release No. 25169 (Dec. 3, 1987) (appeal pending), and In the Matter of the Application of E. F. Hutton & Company, Inc., Securities Exchange Act Release No. 25887 (July 6, 1988). In Antoniu, the Commission upheld the decision of an administrative law judge barring an employee of a registered broker-dealer from association with any broker-dealer based on his conviction for insider trading. E.F. Hutton was a significant case initiated by the National Association of Securities Dealers on the duties of broker-dealers handling customer's open limit orders when the broker-dealer is also making a market in the stock.

The Office is also responsible for defending the Commission in suits challenging the Commission's rulemaking and administrative orders. For example, the Office is representing the Commission in connection with a petition for review of the Commission's Rule 19c-4, which requires the delisting of companies which take certain steps to disenfranchise their

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13/ Accounting and Auditing Enforcement Release No. 200 (Sept. 23, 1988).

shareholders. Business Roundtable v. SEC, No. 88 Civ. 1651 (D.C. Cir. filed Sept. 2, 1988).

The Office also has experienced a significant increase in its non-litigation activity. The Office reviews rulemaking proposals and other significant regulatory actions for consistency with statutory standards and compliance with applicable administrative law requirements. In the legislative area, the Office assists in the preparation and consideration of proposed legislation and Commission testimony before Congress, and responds to Congressional inquiries into issues such as leveraged buyouts and tender offer legislation, insider trading and other enforcement legislation, Glass-Steagall Act amendments, and financial reporting reforms. For instance, the Office rendered substantial technical assistance to Congress in drafting the Insider Trading and Securities Fraud Enforcement Act of 1988. The Office also prepared the proposed "Securities Law Enforcement Remedies Act of 1989" and participated in the preparation of the Commission's proposed "International Securities Enforcement Cooperation Act of 1989."

VII. INTERNATIONALIZATION

Increasing internationalization is one of the most significant recent developments in the securities markets. This development poses significant challenges for the Commission, including the need to adapt regulations and to expand enforcement capabilities to ensure the Commission's ability to protect U.S. investors in the internationalized marketplace.

A. International Securities Enforcement Cooperation Act of 1989

On March 1, 1989, the Commission submitted to Congress a legislative proposal, entitled the "International Securities Enforcement Cooperation Act of 1989." Chairman Dodd and Senator Heinz have introduced this bill in the Senate as S. 646, and Congressman Markey has introduced it in the House of Representatives as H.R. 1396. This proposal would enhance international cooperation in the enforcement of securities laws. The Commission submitted a substantially similar legislative proposal to the Congress in June 1988, part of which was enacted by Congress as Section 6 of the Insider Trading and Securities Fraud Enforcement Act of 1988. 14/ Section 6 amended the Exchange Act to permit the Commission, in its discretion, to provide foreign securities authorities with assistance in investigating possible violations of laws or rules related to securities matters that the requesting authority administers or enforces.

14/ Pub. L. No. 100-704, 102 Stat. 4677.

S. 646 includes three provisions of the June 1988 proposal that were not enacted, as well as two new provisions. In order to facilitate the cooperation of foreign authorities in providing the Commission with investigative assistance, the proposal would exempt confidential records obtained from a foreign securities authority from disclosure requirements under the Freedom of Information Act or other laws. Access for Congress, however, would not be affected. The bill would also make explicit the Commission's rulemaking authority to provide nonpublic documents and other information to foreign and domestic authorities. S. 646 would also amend the Exchange Act, the Investment Advisers Act, and the Investment Company Act to authorize the Commission, based upon the findings of a foreign court or foreign securities authority, to censure, revoke the registration of, or impose employment restrictions upon securities professionals registered to do business in the United States. Finally, the bill would amend the Exchange Act to include a felony conviction as a basis for disqualification from membership in a self-regulatory organization and to permit the Commission to accept reimbursement, from or on behalf of a foreign securities authority, for expenses incurred by the Commission in carrying out investigations for that authority or in providing other assistance.

B. Disclosure Initiatives

The Commission recently has taken several initiatives with respect to disclosure requirements for international transactions. For instance, on June 10, 1988, the Commission proposed Regulation S, 15/ which is intended to clarify the extraterritorial application of the registration provisions of the Securities Act. The regulation would clarify that the registration provisions do not apply to offers and sales of securities outside the United States, and would provide safe harbors for offers, sales, and resales of securities; following the objective procedural standards of the safe harbors would assure that the registration requirements would not apply. In addition, the Commission has proposed a new Rule 144A 16/ that would provide a safe harbor exemption from the Securities Act registration requirements for specified resales of securities to institutional investors. Foreign issuers who may previously have foregone raising capital in the United States due to cost and liability concerns may find private placements in this country a more viable option if proposed Rule 144A and proposed Regulation S are adopted. The Commission's staff also is developing an

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15/ Securities Act Release No. 33-6779 (June 10, 1988), 53 Fed. Reg. 22661 (1988).

16/ Securities Act Release No. 33-6806 (October 25, 1988), 53 Fed. Reg. 44016 (1988).

initial multi-jurisdictional registration experiment with Canada. These and other Commission initiatives designed to address issues raised by the internationalization of the world's securities markets will continue to require substantial staff resources.

C. Elimination of Trade Barriers in the European Community by 1992

The European Community 17/ has adopted a program to develop a single internal market for the Community's goods, services, capital, and labor by the end of 1992. Establishment of such a single market will require the removal of numerous barriers between member states, and the potential transfer of significant regulatory authority from the member states to the European Community. In the securities area, the Community has proposed or adopted directives concerning such matters as stock exchange listings, offering prospectuses, open-end mutual funds, and interim reporting and accounting requirements for certain companies.

Although it is difficult to predict what effect the completion of the European single market will have on the United States, it is possible that removal of barriers to the free flow of capital between member states will allow U.S. securities firms and investment companies to compete more effectively in some European markets, and will open those markets to capital-raising efforts by U.S. issuers. However, it is also possible that the Community will create standards of financial regulation that differ from those existing in the United States. The Commission continues to monitor the program of financial regulation in the European Community with the aim of protecting U.S. investors and promoting the ability of U.S. firms to compete fairly overseas.

D. IOSC Annual Conference

The Commission is a member of the International Organization of Securities Commissions ("IOSC"). IOSC members take turns hosting an Annual Conference, and the Commission has agreed to host the IOSC Conference in 1991. The authorization request includes $100,000 to cover possible Commission costs associated with the Annual Conference.

VIII. GLASS-STEAGALL REFORM

The Commission supports modification of the Glass-Steagall Act, provided that adequate safeguards are enacted to address the

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17/ The member states of the European Community are Belgium, the Federal Republic of Germany, France, Italy, Luxembourg, the Netherlands, Denmark, Ireland, the United Kingdom, Greece, Spain, and Portugal.

investor protection concerns arising from increased bank securities activities. The Commission believes that investors will be adequately protected if banks that engage in securities activities are subject to the same regulations, enforced by the Commission, as are all other entities engaged in those activities.

S. 1886, the "Proxmire Financial Modernization Act of 1988," was passed by the Senate in the 100th Congress. The legislation would have allowed affiliates of commercial banks to underwrite and deal in most securities. To address the significant investor protection concerns raised by the expansion of bank securities activities, Titles III and IV of S. 1886 incorporated amendments to the federal securities laws that were negotiated between the Commission and the bank regulators. Title III would have limited the existing bank exclusions contained in the Exchange Act so that specified securities activities would be subject to Commission regulation. Title IV would have amended the Investment Company Act and the Investment Advisers Act to address concerns arising from bank entry into the investment company business. The bill was referred to the House Banking, Finance and Urban Affairs Committee and the House Energy and Commerce Committee, but the 100th Congress recessed without the House taking action on this legislation.

On January 31, 1989, Senator Dixon introduced in the Senate S. 305, the "Proxmire Financial Modernization Act of 1989." This bill is identical to S. 1886, with a few minor modifications. On the same day, Chairman Dodd introduced in the Senate S. 308, the "Financial Modernization and Safe Bank Act." Chairman Dodd's bill, like S. 305, would expand the securities powers of banks. S. 308 would require that a bank holding company create a securities affiliate if it wished to engage in these expanded powers. The Commission is currently reviewing these legislative proposals.

IX. PROGRAM DIRECTION

A. Administration

Program Direction consists of two major functions -- one, policy management which encompasses policy formulation, information dissemination and management of agency resources, and two, administrative support which provides data processing, logistical, staffing, and financial services necessary to support the agency's mission. As the workload of the operating divisions increases, so does the workload of the Executive Staff. It is important that adequate resources are available to keep up with other agency activity so that Commission policy is developed and applied consistently.

The newly created Office of Inspector General will need additional resources to implement the amendments to the Inspector General Act passed in fiscal year 1989. The audit coverage of Commission programs and data processing operations will be significantly increased to promote economy and efficiency. Evaluations of systems and controls will be emphasized to comply with recently revised government auditing standards. Also, the Inspector General will conduct new internal investigations and other activities.

B. Computerization

The high degree of automation in the securities industry has accelerated during the last 20 years, and the trend toward automation continues. Automation has dramatically changed every facet of the securities industry. The markets themselves have significantly upgraded their automated systems, ranging from data dissemination to order routing, trading, clearance, and settlement systems.

The Commission must likewise devote substantial resources to automated surveillance and regulatory systems. Four of the major areas that the Commission must address are the need for (1) expanded capacity to track diverse yet interrelated securities markets, both domestic and foreign; (2) increased sophistication in tracking and analyzing operations at individual securities firms and their impact on the markets; (3) enhanced systems to evaluate the effectiveness of the self-regulatory organizations' surveillance and monitoring programs; and (4) systems for nationwide registration of broker-dealer registered representatives and of investment advisers.

Periods such as the October 1987 market break have demonstrated the necessity for the Commission to expand its capacity to gather up-to-the-minute information electronically, not only in the nation's securities and futures markets, but also in foreign markets. While the Commission has undertaken several initiatives in this area over the last two years, increased sophistication in the use of outside systems, as well as the Commission's internal information systems, must be a high priority.

C. Salary and Resource Levels

In each of the last six fiscal years, registration, transfer, and other fees have significantly exceeded the Commission's budget, due largely to increased market activity. The Commission received $249 million in 1988 fee revenue, as compared to its appropriation of $135.2 million. Estimated fee collections of $252 million are expected in 1989, as compared to the agency's appropriation of $142.6 million, and $263 million in 1990, as compared to the agency's requested funding of $168.7

million. In contrast to the sharp increase in fees collected and dramatic increases in the Commission's workload, total staff years will remain almost flat during the period 1980 to 1989, from 2,041 to 2,050, based on the most current estimate.

The Congress has recognized the Commission's resource problems, and, at the request of this Subcommittee, the Commission's staff undertook an examination of the agency's staffing problems and the alternatives available to address these concerns. In the study, the staff found that the agency needs special new authorities in order to attract and retain quality staff. Five specific recommendations were developed to accomplish this goal. They are:

- set staff salaries that would take into account competitive salary differentials and would provide regional pay differentials;
- offer retention bonuses to professional staff based on performance;
- fill 100 positions at compensation up to level IV of the executive pay scale for highly qualified lawyers, accountants, or other professionals for specific cases or program management;
- develop and implement pay bands for classifying professional and support staff positions; and
- obtain authority for the Commission to lease space itself and obtain exemptions from GSA space management regulations in order to meet specialized Commission space requirements.

Since these proposals would involve a substantial cost to the agency, the staff study (as to which the Commission itself has expressed no view) offers three options for increased funding, including two special funds that would provide monies for the Commission's operations, subject to Congressional oversight.

D. Effect of Budgetary Freeze Proposals on Commission's Obligations and Objectives

The invitation to Chairman Ruder to testify before the Subcommittee included a request for information with respect to the effect the various "freeze" proposals would have on the Commission's staff levels, as well as on its ability to meet its statutory obligations and current goals and priorities. The Commission understands that two principal budgetary freeze proposals have been discussed. One proposal would keep the 1990 Commission appropriations at the 1989 level, $142.6 million, and

the other would reduce the 1990 appropriations below the 1989 level.

Either proposal would seriously impair the Commission's ability to meet its statutory objectives. Certain expenses that will increase in 1990, such as civil service salaries and employee health benefits, are not within the Commission's control. Consequently, maintenance of the Commission's 1990 appropriations at the 1989 level would necessitate a $1.5 million reduction in non-personnel expenses and a $6.6 million reduction in personnel expenses. The reduction in personnel expenses would result in a loss of 132 staff years by the end of 1990, which could be achieved through an absolute hiring freeze and normal attrition. A reduction in the Commission's funding level in 1990 would require even more extreme measures, such as involuntary personnel reductions, early retirements, mandatory unpaid leave, and permanent dismissals.

These freeze proposals, and the consequent reduction in staff, would seriously impair the Commission's ability to carry out its statutory responsibilities and meet its current objectives. The Commission is already suffering from a shortage of resources, and an additional reduction would further hinder the Commission's efforts. In particular, a freeze would reduce the Commission's ability to enforce the securities laws, to inspect and supervise regulated entities, and to review disclosure filings. Consequently, such a freeze would not be in the interest of investors or the securities markets.

To avoid these consequences, the Commission urges that the Congress and the Executive craft a budget compromise that addresses the budget deficit while permitting continued effective enforcement of the nation's securities laws. Needless to say, if the Commission's budget is reduced, the Commission will take whatever steps are feasible to continue effectively to enforce the securities laws with less manpower and resources. 18/

18/ Commissioners Fleischman and Cox concur in the desirability in general of each of the several programs described in this Testimony and in the inevitable logic of an Authorization Request directed to the accomplishment of such programs, but do so with two serious reservations arising from Gramm-Rudman-Hollings mandates: first, that the Testimony fails to explain why an exception should be made to across-agency "freeze" proposals so as to result in less impairment of the Commission's ability to fulfill its particular statutory objectives than of the ability of other affected executive and regulatory agencies to meet the responsibilities of their respective governing statutes; and, second, that the Testimony fails to explain which of the several programs,

(continued...)

* * *

We appreciate this opportunity to present the Commission's 1990-1992 authorization request.

18/(...continued)
present or prospective, claims what rank among the Commission's priorities in addressing the multifold statutory objectives for which it has been made responsible.

In addition, Commissioner Fleischman questions the omission of any request for funds for a study of the nation's capital markets, authorized in late 1988 by Pub. L. No. 100-704.