U.S. Securities and Exchange Commission

Testimony Concerning Appropriations for Fiscal 2003

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Chairman Wolf, Ranking Member Serrano, and Members of the Subcommittee:

Thank you for the opportunity to testify before you today on behalf of the Securities and Exchange Commission regarding the President's fiscal 2003 budget request. This is the first time I have appeared before this Subcommittee, and I want to begin by expressing my gratitude, and that of the entire SEC, for the tremendous bipartisan support this Subcommittee and its staff have given the Commission over the years. I look forward to continuing this strong and positive working relationship.

The past eight months have tested the mettle and resiliency of our country, our markets, and the investing public's confidence. With the events of September 11th, the bankruptcy of Enron and, just last month, the indictment of Arthur Andersen, we have witnessed how critical our appropriately vaunted capital markets are to the strength, security and spirit of our Country and our economy. As the complexity of our financial markets continues to grow unabated, and the number of Americans who participate in them steadily increases, the Commission must ensure that its traditional high standards are not compromised. Given this backdrop, it is critical that the SEC have the resources it needs to fulfill its multiple missions. We need those resources if we are to restore the public's full confidence in our capital markets.

When I returned to the SEC last fall, I had hoped to have the opportunity to perform an in-depth review of the Commission's operations, effectiveness, and resource needs in time for the fiscal 2003 budget process. The events of the past eight months, including the destruction of our Northeast Regional Office, made any comprehensive review of our resource needs impossible at that time. On March 20th, I announced the commencement of a four-month internal special study to examine our resource allocations and needs. The results of this effort will be included in our fiscal 2004 budget request.

Proposed Funding Level

The President's budget for fiscal 2003 requested an appropriation of $466.9 million for the Commission, an appropriation that I supported when it was first formulated. But, since the time that appropriation was formulated, pay parity legislation has passed, and the Commission has had to respond to three major crises. As a result of those recent events, we critically need additional funds to enable us to phase-in a modest pay parity plan for fiscal 2003. We also need to add new staff to address pressing immediate needs.

The proposed funding level of $466.9 million for fiscal 2003 - which excludes $13 million that would be provided to the SEC to fund the Administration's retirement accrual proposal, if enacted - is approximately 6.6 percent more than our fiscal 2002 budget of $437.9 million.[1] This proposed funding level provides the SEC with a "zero-growth" budget in that it provides no new staff and only modest amounts for the SEC's e-government and information technology initiatives, telecommunications systems, and security enhancements. The Commission has not received a staffing increase in the last two years, despite the additional responsibilities we have received as a result of enactment of the Commodity Futures Modernization Act and the Gramm-Leach-Bliley financial services modernization act. If the SEC remains at its current staffing level, the agency will be required to continue to divert resources from other program areas to meet our enforcement needs and to address the additional initiatives we are undertaking to improve financial reporting and disclosure.

Pay Parity

The Commission has been subject to extremely high attrition, in part because our employees earn substantially less than their counterparts in the other financial service regulatory agencies. The "Investor and Capital Markets Fee Relief Act" (P.L. 107-123), enacted this January, authorized pay parity, but the Administration's proposed fiscal 2003 SEC budget provides no new money to implement this vitally important program. Now that pay parity is law, however, the failure to provide funding would be a crushing disappointment to our most valued employees. We estimate that an *additional* $76 million is needed to provide pay parity for the agency in fiscal 2003.[2] At this critical time for the Nation's financial markets, the SEC must be able to keep our most experienced, talented, valuable and productive employees. The only way I believe we can do that is to provide staff with pay at levels comparable to those with whom they regularly work at the other federal financial regulatory agencies.

Pay parity has been and remains my highest budget priority. In making this funding request, I am grateful to have bipartisan backing from this Committee, and the SEC's House oversight body, the Financial Services Committee. I am especially grateful to you, Chairman Wolf and Ranking Member Serrano, for recently approving the reprogramming of funds necessary to implement partial pay parity in fiscal 2002. The Office of Management and Budget has now apportioned the use of those funds, and we are awaiting the commencement of negotiations with the National Treasury Employees Union regarding certain aspects of the pay parity system for bargaining unit staff. I also want to thank you, Mr. Chairman, for writing the Administration to express your support for full funding of pay parity in fiscal 2003. This is a crucial time in the development and strategic future direction of our capital markets. The SEC cannot afford to continue suffering the staffing crisis it has endured for the past decade. With your assistance, pay parity will provide the benefits we truly need to meet the increasing regulatory challenges we face.

I can assure you that the SEC intends to make responsible increases in staff salaries and benefits and to ensure the appropriate use of merit and performance-based principles. We have described our plan to implement pay parity in our Pay Parity Implementation Report which we submitted on March 6, 2002 to Congress and the Office of Personnel Management as we were required to do under the Investor and Capital Markets Fee Relief Act. Our $76 million cost estimate represents a conservative approach that is lower than the amount that we believe would be required to match what several of the banking agencies currently provide. A fully implemented system identical to the FDIC model, for example, could easily cost more than $100 million. In addition, we do not intend to provide large-scale, across-the-board increases. Instead, we intend to base our system on the intent of Congress and begin a modest, considered approach to pay parity that we can assess responsibly before including additional benefits. Merit will be an integral component of any program we put in place.

Failure to continue funding pay parity beyond fiscal 2002 would only exacerbate the problems that the legislation passed by Congress last December was intended to cure. By temporarily raising salaries and expectations of finally achieving lasting pay parity relief, I believe we will face even greater employee losses and suffer irreparable harm to morale if pay parity is not funded in fiscal 2003 and thereafter. The threat of either terminating our pay parity program in fiscal 2003 or terminating approximately 700 employees — the number we estimate would have to be cut from the agency to continue pay parity — would cripple many of the projects we have underway, which are important for the protection of investors and Americans whose retirement accounts are invested in the securities of public companies.

So, if there is one message I can leave with you today, it is: Please, please fully fund pay parity for the SEC in fiscal 2003.

Additional Staffing Needs

Because of recent events, we need to restore full confidence in our capital markets, and I believe we need additional personnel to be sure we achieve our goals. Accordingly, when I testified on the SEC's budget before the Senate last month, I requested that our fiscal 2003 staffing level be increased by 100 positions to meet our immediate resource needs. Since that hearing, the Administration has submitted its supplemental budget request to Congress and included in it $20 million to fund these positions. We are very grateful for the Administration's support. They have been extremely receptive to our request and willing to work with us to meet our resource needs. These 100 positions would allow us to add:

- 35 accountants and lawyers in the Division of Enforcement to deal with the increasing workload from financial fraud and reporting cases. To give you a sense of scale of this increasing workload, consider that over the first two months of this year, the Division of Enforcement opened 49 cases investigating financial fraud and reporting, compared to 18 cases opened over the same time period last year.

- 30 professional staff, including accountants and lawyers, in the Division of Corporation Finance to expand, improve and expedite our review of periodic filings. Our Division of Corporation Finance has undertaken to monitor the annual reports submitted by all Fortune 500 companies that file periodic reports with the Commission in 2002. This new initiative, which we announced in December, significantly expands the Division's review of financial and non-financial disclosures made by public companies.

- 35 accountants, lawyers, and other professionals in the other divisions — including the Office of Chief Accountant — to deal with new programmatic needs and policy.

These 100 positions are the minimum staffing levels I believe we require to deal with our *immediate* post-Enron needs.

I ask for your support to fund these additional positions to enhance our accounting oversight, disclosure and enforcement programs. The Administration's decision to include $20 million in the supplemental budget request responded to our request for $15 million to fund these positions beginning in fiscal 2003. It is my understanding that these $20 million in funds were included in the supplemental budget request to cover the fiscal 2002 *and* 2003 costs associated with 100 new positions. We are extremely grateful to the Administration for recognizing and addressing our immediate needs. If we are able to fill these new staff positions by summer, we estimate we will spend approximately $5.5 to $6.5 million of the total $20 million in fiscal 2002, which could result in a shortfall for fiscal 2003. I have spoken with the Office of Management and Budget, and they agree that a shortfall was not intended and have said they will work with us to ensure our staffing needs are satisfied.

Special Study

As I mentioned at the beginning of my testimony, we have just begun a special four-month study to examine the Commission's operations, efficiency, productivity, and resource needs in preparation for our upcoming fiscal 2004 budget submission. This special study is intended, in part, to identify efficiencies that we can employ and to examine closely our need for additional resources throughout the agency. The study also addresses some recent recommendations of the General Accounting Office in its study of the Commission's human capital, strategic planning activities, and resource needs. We may need additional resources, for example in our examination program to meet our goals for timely and frequent on-site exams of investment companies and advisers, broker-dealers, and the exchanges. I anticipate completing this study by the end of July and will ensure that this Committee is kept fully apprised of our progress and recommendations. I expect the results of the special study to be consistent with the President's Management Agenda.

The remainder of my testimony addresses other ongoing initiatives we are undertaking in the areas of enforcement, corporate disclosure and accounting, investor education and technology.

Real-time Enforcement

One of our major new initiatives — "real-time" enforcement — is an important component of our fiscal 2003 budget. Our goal is to provide quicker, and more effective, protection for investors, and better oversight of the markets with our limited enforcement resources. As recent experience has reinforced, the SEC must resolve cases and investigations *before* investors' funds vanish forever; that means we must act more quickly, both in identifying violations and taking prompt corrective action to protect investors. Faster enforcement can help prevent continued fleecing of public investors and dissipation of assets, and will promote investor confidence in the integrity of our markets. As a result, you will see us moving faster to obtain temporary restraining orders, freezes of assets, and appointment of court monitors to oversee enterprises that commit securities fraud. As of April 10, 2002, just about halfway through our fiscal year, our Division of Enforcement has sought emergency relief, including temporary restraining orders and asset freezes, in 36 cases, compared to 43 over the entire fiscal 2001; suspended trading in 7 securities, compared to 2 in all of fiscal 2001, and brought 14 subpoena enforcement actions, compared to 13 in all of fiscal 2001. The surest way to protect investors is with an enforcement program that is focused on the needs of investors. These statistics show we are committed to that goal. These efforts necessarily require resources, the most important of which is appropriate staffing. An immediate staffing increase of 35 accountants and lawyers in our Division of Enforcement, which I have already outlined, would strengthen our real-time enforcement program, especially in the area of financial fraud and reporting cases, which involve complex and time-consuming investigations.

Disclosure and Accounting

Recent events also have underscored the need for public companies to have a strong commitment to full disclosure, accounting and compliance with all regulatory regimes to which their companies are subject. In his State of the Union Address, the President appropriately demanded "stricter accounting standards and tougher disclosure requirements." He also stated that he wants corporate America to "be made more accountable to employees and shareholders and held to the highest standard of conduct." On March 7, the President outlined a substantive, serious, and thoughtful program to move toward implementation of these goals. The SEC has embraced the President's program, and we are firmly committed to making it a reality.

Last week, we proposed changes in corporate disclosure rules as the first in a series of steps designed to improve our financial reporting and disclosure system. The proposed rules would require companies to report transactions by company insiders on a current basis and in a complete manner. They also would expedite the filing of existing periodic reports. Shortly, we anticipate proposing rules that would require companies to report additional critical information on a current basis and in a complete manner, such as critical accounting policies and changes in rating agency decisions.

While these proposed rules are only a first step, if enacted they would provide the most dramatic and significant improvements in our disclosure system in at least two decades, and they could be implemented quickly while other, more sweeping proposals are considered. During the remainder of 2002, we anticipate proposing further comprehensive reform proposals covering financial reporting and disclosure requirements, accounting standard setting, regulation of the auditing process and profession and corporate governance. These initiatives include the following:

- *A "current" disclosure system.* Investors need current information, not just periodic disclosures. We want investors to have an accurate and current view of the posture of their company, as seen through the eyes of management. Public companies should be required to make affirmative disclosures of unquestionably material information in real time, including providing updates to prior disclosures.

- *Public company disclosure of significant current "trend" and "evaluative" data.* Providing current trend and evaluative data would enable investors to assess a company's evolving financial posture. This information, upon which corporate executives and bankers already base critical decisions, can be presented without confusing or misleading investors, prejudicing legitimate corporate interests or exposing companies to unfair assertions of liability.

- *Clear and informative financial statements.* Investors, and employees concerned with preserving and increasing their savings and retirement funds, deserve comprehensive financial reports they can easily and quickly interpret and understand.

- *Conscientious identification and assessment of critical accounting principles.* Public companies should be required to identify the most critical accounting principles upon which a company's financial status depends, and which involve the most complex, subjective, or ambiguous assessments. Investors should be told, concisely and clearly, how these principles are applied, and should be informed about a range of possible effects in differing applications of these principles.

- *More meaningful investor protection by audit committees.* Audit committees must be proactive, not merely reactive, to ensure the quality and integrity of corporate financial reports. Especially critical is the need to improve interaction between audit committee members and senior management and outside auditors. Audit committees must understand why critical accounting principles were chosen, how they were applied, and have a basis to believe the end result fairly presents the company's actual status.

- *Effective oversight of those who audit public companies.* We are firmly committed to taking a lead role in assuring that the accounting profession functions properly, expeditiously and in the public interest. To that end, we are addressing how best to restructure the regulatory system that governs the accounting profession. We envision a regulatory body that will assume responsibility for auditor and accountant discipline and quality control. A substantial majority of its members would be unaffiliated with the accounting profession, and the oversight body would be funded *not* by the accounting profession but from the private sector.

- *Ensuring those entrusted with the important public responsibility of auditing public companies are single-minded in their devotion to the public interest, and not subject to conflicts that might confuse or divert them.* Those who perform audits must be truly independent and in particular must not be subject to the conflict of increasing their own compensation at the risk of ensuring the public's protection. Their fidelity to the cause of full, fair and understandable financial reporting must be ironclad and unequivocal.

These are just some of the initiatives that we are working on, both on our own and together with Congress, the President's Working Group, investor groups and other SEC constituents to improve corporate disclosure and accounting. These initiatives, if done properly and responsibly, will require additional resources to plan and implement, if we are to keep up with our existing, on-going responsibilities at the same time. Regrettably, at this time, I cannot give you even an estimate of those costs. We are studying this currently. But, in light of the events of the past eight months, I think it is foreseeable that the SEC will require additional funding to implement improvements to our corporate disclosure and accounting systems.

Investor Education

Even with our shift toward real-time enforcement and our current efforts to improve financial disclosure, the first line of defense against fraud is always an educated investor. The Commission works with numerous public and private organizations to foster investor educational programs. Our staff gives presentations to countless schools, religious organizations, and investor clubs, explaining basic investing concepts and answering questions. We also host "Investor Town Meetings" across the United States, that bring together industry, federal, and local government officials to educate investors on basic financial concepts.

Over the past several months, we have been seeking input broadly on both corporate disclosure and auditor regulation. To that end, we held Roundtables, on March 4 in New York City, March 6 in Washington, D.C. and April 4 in Chicago, with distinguished business executives, lawyers, accountants, academics, regulators, and public interest representatives, who discussed various proposals and helped advance our understanding and insight into these issues. On May 10, we will host our first "Investor Summit" in Washington DC to discuss with investors policies and proposals that impact them. We want to give all Americans an opportunity and an avenue to weigh in on the broad policy objectives that ultimately could impact their ability to send their children to college or retire comfortably. We plan to use the Internet to broadcast the summit so that anyone can participate. We also are asking people to write us and call us so that we can hear the broadest possible range of viewpoints. We want to hear the concerns and aspirations of America's investors.

Information Technology

Like the rest of the government, our needs in the area of information technology continue to increase. Given the critical and increasing role of technology in the financial markets, the President's budget requests $4.0 million to fund the SEC's e-government initiatives. This is an area where the Commission needs to improve, both internally and externally. Technology is constantly altering the landscape of our markets, and SEC staff must have the necessary tools at their disposal to successfully meet the increasing demands that we face. In particular, funds proposed for fiscal 2003 will allow the SEC to get better and more timely enforcement information from the markets, enhance our intrusion detection capabilities, and meet the

President's security requirements for information technology. These initiatives are a small, but important, first step toward meeting the Commission's technology needs.

With the advent of alternative trading systems that have grown from only a handful to over 60 today, and as a result of the Internet, the SEC also must consider what effect our regulatory actions and decisions have on the industry's use of technology. Toward that end, I would like to thank you for recently approving the creation of a Chief Technology Officer position to provide us with the technical expertise and advice necessary to improve our oversight of the markets. Generally, this office will be responsible for ensuring that the SEC's regulatory, disclosure, examination, and law enforcement programs are implemented with the benefit of a state-of-the-art understanding of technology. Through this process, the agency can be confident that what we implement or approve is technologically sound and cost effective to the private sector.

Funding Structure

Last, I want to thank you again for your support in helping enact the recent fee reduction/pay parity legislation that I discussed earlier in my testimony. This new law is extremely important to the SEC and the securities industry, which has consistently supported both fee reduction and pay parity. The new legislation not only reduces potential excess fees paid by investors and provides authority for pay parity for the Commission's staff, but also provides the SEC with a stable, long-term funding structure, which is consistent with the original fee structure implemented to fund the SEC.

Under the fee reduction/pay parity legislation, the Commission is slated to collect a total of $1.33 billion in offsetting collections in fiscal 2003, $180 million more than this year's estimate. Even after funding pay parity and the additional positions described above, the Commission will still collect more than $750 million in fees than its fiscal 2003 budget request.

The fee reduction/pay parity legislation requires the Commission to adjust fee rates on a periodic basis after consulting with the Congressional Budget Office and the Office of Management and Budget. While the fee rates are going to be higher than anticipated in the short term, due to changes in the economy and declines in market indices since CBO developed its original dollar volume estimates over a year ago, we firmly believe that over the longer term the fee reduction legislation will provide the investing public with the benefits and security it was designed to provide, in addition to benefiting the Commission and this Subcommittee by providing a stable, long-term funding source.

Conclusion

The SEC regulates industries and markets that have grown enormously in both size and complexity. The Commission currently oversees an estimated 8,000 brokerage firms employing nearly 700,000 brokers; 7,500 investment advisers with approximately $20 trillion in assets under management; 34,000 investment company portfolios; and over 17,000 reporting companies. The Commission also has oversight responsibilities for nine registered securities exchanges, the National Association of Securities Dealers, the National Futures Association, 13 registered clearing agencies, and the Municipal Securities Rulemaking Board.

The SEC currently oversees these industries and markets with modest staff and limited resources, operating in conjunction with the states and self-regulatory organizations. This cooperative structure enables the Commission to leverage its resources to fulfill its missions, but leverage can only go so far. Without knowing exactly where and how many, I can say with certainty that the SEC needs more staff; that is why I have recommended an immediate fiscal 2003 increase of 100 key professional staff and will be making a more thorough, agency-wide assessment over the next several months.

I take quite seriously my stewardship responsibilities and the Oath of Office I took regarding the Commission and its resource needs. I am confident that we can work together to ensure that the SEC has sufficient resources to ensure that our markets remain the envy of the world and are as fair and transparent to all investors as we can possibly make them. Thank you for the opportunity to testify today. I am pleased to respond to any questions the Subcommittee may have.

Endnotes

[1] In fiscal 2002, the Commission also received a supplemental appropriation of $20.7 million to cover some of the costs associated with rebuilding our Northeast Regional Office and increasing security agency-wide.

[2] In fiscal 2001, the Commission received approval and funding to implement "special pay" to help begin addressing our recruitment and attrition problems. In fiscal 2002, we also received funding to continue special pay. The appropriation proposal for fiscal 2003 provides $19 million to fund special pay. We estimate that an additional $76 million is needed to fund pay parity for fiscal 2003.

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