United States General Accounting Office

GAO

Report to Congressional Requesters

March 2002

SEC OPERATIONS

Increased Workload Creates Challenges

GAO

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GAO-02-302

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Highlights

SEC OPERATIONS
Increased Workload Creates Challenges

Highlights of GAO-02-302, a report to Paul S. Sarbanes, Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate; Christopher J. Dodd, Chairman, Subcommittee of Securities and Investment; and Jon S. Corzine, Member, Committee on Banking, Housing and Urban Affairs, U.S. Senate.

Why GAO Did This Study

In the past decade, securities markets have undergone tremendous growth and innovation. Responding to concern that the Securities and Exchange Commission's (SEC) workload has outgrown its resources and impaired SEC's ability to fulfill its mission, GAO undertook a study to (1) determine how the securities markets have changed, (2) identify whether SEC's resource levels have affected its ability to regulate and oversee the markets, and (3) identify any other factors that may affect SEC's ability to fulfill its mission.

What GAO Recommends

GAO recommends that SEC explore short- and long-term recommendations to address its current challenges. In the short-term, SEC should ensure that it explores ways to use all of its available resources to address its recruiting and retention problems.

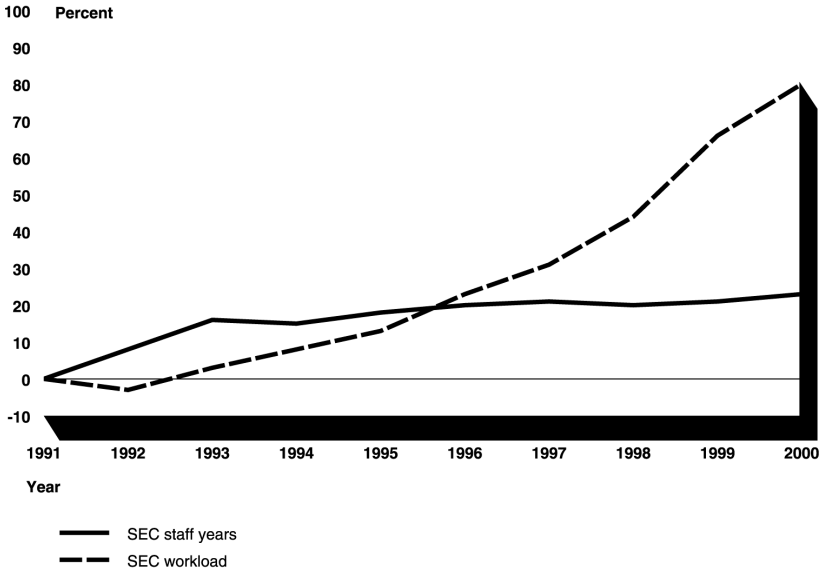
In the long-term, we recommend that SEC broaden its strategic planning process to determine its regulatory priorities and the resources needed to fulfill its mission, including identifying the skills needed.

SEC, generally, agreed with the report's findings, conclusions, and recommendations.

What GAO Found

U. S. securities markets have grown tremendously and become more complex and international. As a result, SEC's workload has increased in volume and complexity over the past decade. As illustrated below, around 1996, SEC's workload (e.g., filings, applications, and examinations) started to increase at a much higher rate than SEC staff years devoted to this workload. Although industry officials said that they respect SEC as a regulator, they said that SEC's limited staff resources have resulted in substantial delays in SEC regulatory and oversight processes, which hampers competition and reduces market efficiencies. In addition, they said information technology issues need additional funding, and SEC needs more expertise to keep pace with rapidly changing financial markets. Finally, the officials said that SEC's reliance on a small number of seasoned staff to do the majority of the routine work does not allow those staff to adequately deal with emerging issues.

Although most officials said that SEC's resource limitations create challenges for SEC, they identified other contributing factors. First, SEC's high staff turnover has resulted in it having a more inexperienced staff, which contributes to the identified delays in SEC's regulatory processes. Second, existing securities laws, which require SEC approval of most market innovations and new products, can contribute to regulatory bottlenecks. Finally, SEC's budget and strategic planning processes could be better linked to help SEC identify the types and amounts of additional resources needed to fulfill its mission.



Source: GAO analysis of SEC data.

This is a test for developing highlights for a GAO report. The full report, including GAO's objectives, scope, methodology, and analysis is available at *www.gao.gov/cgi-bin/getrpt?GAO-02-302*. For additional information about the report, contact Richard J. Hillman (202-512-8678). To provide comments on this test highlights, contact Keith Fultz (202-512-3200) or email *HighlightsTest@gao.gov*.

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Abbreviations

ARP	Automation Review Policy
ATS	alternative trading system
ECN	electronic communication network
EDGAR	Electronic Data Gathering Analysis and Retrieval
GLBA	Gramm-Leach-Bliley Act of 1999
GPRA	Government Performance and Results Act
IA	investment adviser
IARD	investment adviser registration depository
IC	investment company
IG	inspector general
IPO	initial public offering
OCIE	Office of Compliance Inspections and Examinations
OMB	Office of Management and Budget
SEC	Securities and Exchange Commission
SRO	self-regulatory organization

G A O
Accountability * Integrity * Reliability

United States General Accounting Office
Washington, DC 20548

March 5, 2002

The Honorable Paul S. Sarbanes
Chairman, Committee on Banking, Housing, and
Urban Affairs
United States Senate

The Honorable Christopher J. Dodd
Chairman, Subcommittee on Securities and Investment
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Jon S. Corzine
United States Senate

The securities markets have undergone tremendous change and innovation over the last decade, and the Securities and Exchange Commission (SEC) faces growing regulatory and oversight challenges to stay abreast of these advances. More recently, the sudden highly publicized collapse of Enron Corporation has increased the pressure on SEC to ensure that investors receive accurate and meaningful financial disclosure, an important part of SEC's mission to protect investors. In addition, technological advances have increased the complexity of securities markets and the range of products offered to the public. Moreover, technology has changed the way investors can buy and sell securities, for example through on-line brokerages, and how investors are solicited, given the increased access to information on the Internet. These changes and the internationalization of securities markets have presented SEC with increasing responsibilities in a dynamic regulatory environment. Also, legislative changes, such as the Gramm-Leach-Bliley Act of 1999 (GLBA), the Commodity Futures Modernization Act of 2000, and the USA PATRIOT Act of 2001, place added demands on SEC. Because more individuals and families are now invested in the markets, the role SEC plays has become even more important to the investing public.

You asked that GAO review whether SEC had sufficient resources to stay abreast of the changes in the markets. Our objectives were to (1) identify how securities markets have changed, (2) determine whether SEC's resource levels and workload have affected SEC's ability to regulate and oversee the markets, and (3) identify any other factors that may affect SEC's ability to fulfill its mission.

In addressing these objectives, we analyzed securities market and available SEC workload trend data. However, in certain instances, quantifiable data was not provided to us for workload measures, such as the length of review and approval processes conducted within SEC divisions. We met with various knowledgeable SEC and industry officials to obtain their views on whether these processes were affected by SEC's existing workload demands and resources levels. To obtain information on whether SEC's ability to regulate and oversee the markets has been affected by resource constraints, we interviewed current and past SEC officials, including division and office directors, regional office directors, budget officials, former commissioners, and academics. In addition, we interviewed numerous industry officials, including those from various exchanges, associations, investment companies, and broker-dealers. We also asked these parties about any other factors that might affect SEC's ability to fulfill its mission. We also reviewed relevant GAO and inspector general reports on SEC's oversight activities. Finally, we reviewed and evaluated SEC's strategic plan and Government Performance and Results Act (GPRA) reports.

Background

SEC's primary mission is to protect investors and the integrity of the securities markets. SEC seeks to (1) promote full and fair disclosure, (2) prevent and suppress fraud, (3) supervise and regulate the securities markets, and (4) regulate and oversee investment companies, investment advisers, and public utility holding companies. It works to fulfill this mission through various divisions and offices. In 2001, GAO issued a report that addressed many of the human capital challenges SEC faces.[1]

SEC Focuses on Disclosure, Oversight, and Enforcement

SEC fulfills its mission to protect investors and the integrity of securities markets through activities focused on disclosure, oversight, and enforcement. The laws and rules governing the securities industry are based on the concept that all investors, whether large institutions or private individuals, should have access to basic information about an investment prior to trading. To achieve this, the securities laws require public companies to register with SEC and to periodically make public

[1] U.S. General Accounting Office, *Securities and Exchange Commission: Human Capital Challenges Require Management Attention*, GAO-01-947 (Washington, D.C.: Sept. 17, 2001).

meaningful financial and other information for all investors to use to determine whether a company's securities are an appropriate investment.

SEC also oversees the activities of a variety of key market participants. In 2001, SEC was responsible for 9 exchanges, the over-the-counter market, approximately 70 alternative trading systems (ATSs), [2] 12 registered clearing agencies, about 8,000 registered broker-dealers employing over 700,000 registered representatives, almost 8,000 transfer agents,[3] over 5,000 investment companies and 7,400 registered investment advisers. In addition, over 14,000 companies that have issued securities filed annual reports with SEC. SEC's oversight includes rulemaking, surveilling the markets, interpreting laws and regulations, reviewing corporate filings, processing applications, conducting inspections and examinations, and determining compliance with federal securities laws. SEC is also responsible for regulating public utility holding companies.

Each year SEC brings hundreds of civil enforcement actions against individuals and companies that violate securities laws. Violations include insider trading, financial and accounting fraud, providing false or misleading information about securities and the companies that issue them, selling of securities without proper registration, and violating broker-dealer responsibility to treat customers fairly. An ongoing program to educate investors and ensure that their concerns are known throughout SEC supplements SEC's enforcement efforts.

SEC's Organizational Structure

As of September 30, 2001, SEC had 3,285 staff (or 2,936 full-time equivalent staff years) working in 4 divisions and 18 offices in Washington, D.C. and in 11 regional and district offices. Of these, approximately 39 percent were attorneys, 18 percent were accountants or financial analysts, and 6 percent were investigators or examiners. The remaining 37 percent were various other professional, technical, administrative, and clerical staff. See figure 1 for a description of SEC's major divisions and offices.

[2] An ATS is any entity that performs functions commonly performed by a stock exchange.

[3] Transfer agents are parties that maintain records of stock and bond owners.

Figure 1: SEC Divisions and Selected Offices

The Division of Corporation Finance oversees corporate disclosure of important information to the investing public. Public corporations are required to comply with regulations pertaining to disclosure that must be made when stock is initially sold and then on a continuing and periodic basis. This division routinely reviews the disclosure documents filed by public companies. It also provides public companies with assistance interpreting SEC's rules and recommends new rules for adoption.

The Division of Enforcement investigates possible violations of securities laws, recommends SEC action, when appropriate, either in a federal court or before an administrative law judge, and negotiates settlements on behalf of the SEC commissioners. While SEC has civil enforcement authority only, it works closely with various criminal law enforcement agencies such as the Department of Justice and U.S. Attorney General offices throughout the country to develop and bring criminal cases when the misconduct warrants more severe action.

The Division of Market Regulation establishes and maintains standards for fair, orderly, and efficient markets. It does this primarily by regulating the major securities market participants including broker-dealers, self-regulatory organizations (SROs), transfer agents, and securities information processors.

The Division of Investment Management oversees and regulates the investment management industry and administers the securities laws affecting investment companies, including mutual funds and investment advisers. In applying the federal securities laws to this industry, this division seeks to improve disclosure and minimize risk for investors without imposing undue costs on regulated entities. The division also administers the Public Utility Holding Company Act of 1935.

The Office of Compliance Inspections and Examinations administers SEC's nationwide examination and inspection program for registered SROs, broker-dealers, transfer agents, clearing agencies, investment companies, and investment advisers. This office conducts inspections to promote compliance with the securities laws, to detect violations of the law, and to keep the SEC commissioners informed of developments in the regulated community.

The Office of Economic Analysis advises the SEC commissioners and SEC staff on the economic issues associated with SEC's regulatory and policy activities. This office analyzes the potential impacts and benefits of proposed regulations, conducts studies on specific rules, and engages in long-term research and policy planning.

The Office of the General Counsel is the chief legal officer of SEC. Primary duties of this office include representing SEC in certain civil, private, or appellate proceedings, preparing legislative material, and providing independent advice and assistance to the SEC commissioners, the divisions, and the offices.

The Office of Investor Education and Assistance serves individual investors, ensuring that their problems and concerns are known throughout SEC and considered when the agency takes action. Investor assistance specialists answer questions, analyze complaints, and seek informal resolutions.

The Office of Information Technology is responsible for supporting the SEC commissioners and SEC staff in all aspects of information technology. This office operates the Electronic Data Gathering Analysis and Retrieval (EDGAR) system, which electronically receives, processes, and disseminates more than 500,000 financial statements every year. This office also maintains SEC's Web site.

Other SEC offices: administrative law judges; administrative and personnel management; chief accountant; comptroller; equal employment opportunity; executive director; filings and information services; inspector general; international affairs; legislative affairs; public affairs, policy evaluation, and research; and the office of the secretary. SEC regional and district offices include field staff to conduct its enforcement, examination, and inspection functions.

Source: SEC.

2001 GAO Report Found SEC Faces Human Capital Challenges

In 2001, we issued a report, which discussed the human capital challenges SEC faces.[4] We surveyed current and former SEC attorneys, accountants, and examiners to determine why they had left or would consider leaving SEC. Overwhelmingly, compensation was cited as the primary reason for leaving. Respondents also identified other nonpay factors that had or would affect their decisions to leave, such as the lack of opportunities for advancement, the amount of uncompensated overtime, and the quality of administrative support.

To recruit, retain, and motivate employees, we found that SEC used various compensation-based programs, such as recruitment bonuses, retention allowances, and special pay rates, more actively than other government agencies. For example, in March 2001, SEC received OPM approval to update its special rates for attorneys, accountants, and examiners. These special pay rates are generally equivalent to a several-step increase in the basic government pay scale. Because staff cannot receive the special pay rate and a locality pay adjustment, SEC would have to request special pay adjustments annually to prevent the locality pay adjustments from eroding the benefit of the special pay.

We also found that while SEC also offers a number of work life programs, it has only recently increased its focus on providing greater flexibilities to its staff such as opportunities to work compressed work schedules. We also found that SEC management had made improvements to its recruitment program, which included additional training for recruiters and expanded on-campus recruiting and added a new human capital goal to its performance plan. However, more remains to be done in order for SEC to strategically align its core mission with its ability to recruit and retain qualified employees. We recommended that the chairman, SEC, periodically survey employees to measure job satisfaction, identify employee concerns, and analyze the effectiveness of the agency's programs to retain employees. We also recommended that the chairman, SEC, include a strategy for succession planning and a comprehensive, coordinated workforce planning effort in the agency's annual performance plan. Finally, we recommended that the chairman, SEC, identify ways to involve human capital leaders in decision making and establish a practice that requires management to continually ensure the effectiveness of SEC's human capital approaches in addressing employees' needs, including

[4] GAO-01-947.

working with the National Treasury Employees Union to expeditiously address the areas of dissatisfaction identified in our survey.[5]

Securities Markets Have Become Larger and More Complex

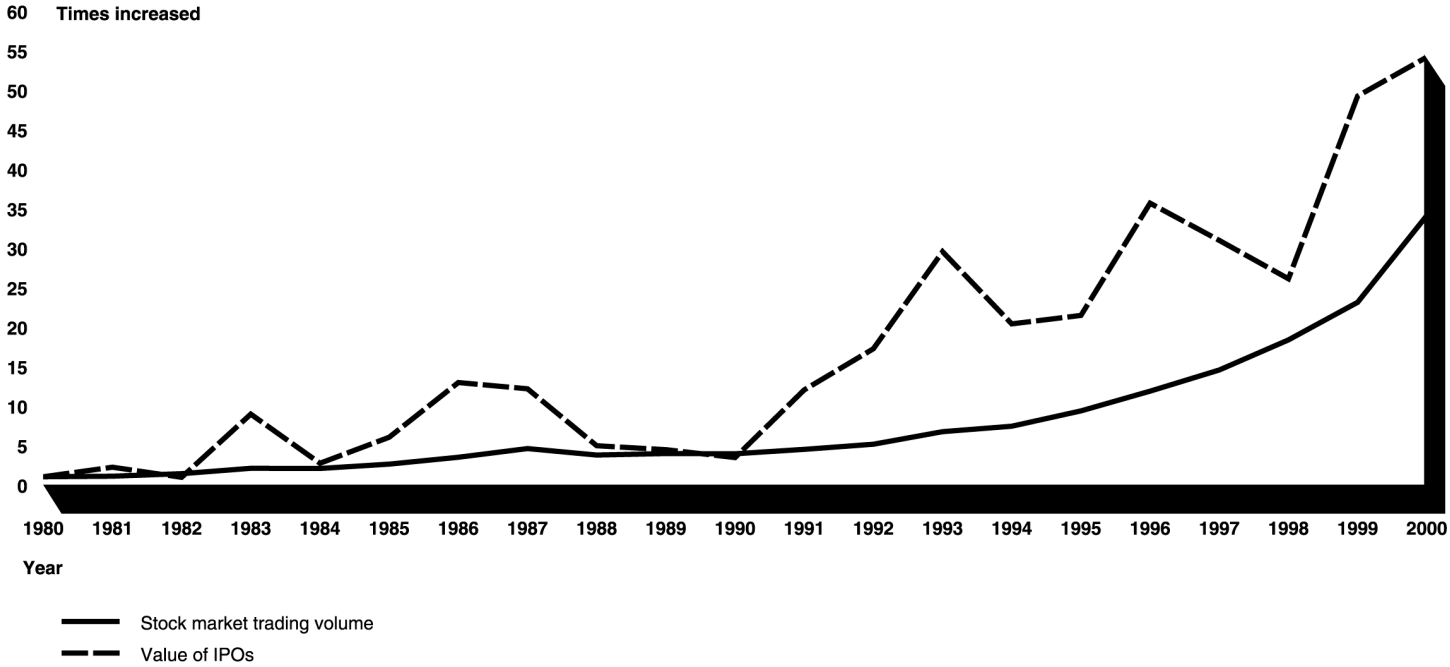
Over the last decade, securities markets have experienced unprecedented growth and change. Moreover, technology has fundamentally changed the way markets operate and how investors access markets. These changes have made the markets more complex. In addition to these market-driven changes, the markets have become more international, and legislative changes have resulted in a regulatory framework that requires increased coordination among financial regulators and requires that SEC regulate a greater range of products.

U.S. Capital Markets Have Grown Rapidly

Over recent decades, U.S. capital markets have experienced substantial growth, especially in the 1990s. As shown in figure 2, the volume of shares traded in U.S. stock markets in 2000 was over 30 times higher than the volume in 1980. Although many factors contributed to this unprecedented growth, it was in part spurred by technological advances and decreasing transaction costs, which made it easier and more affordable for investors to participate in the market. Figure 2 also shows that the value of initial public offerings (IPOs) of securities issued in 2000 was over 50 times the number of IPOs issued in 1980 as private companies took advantage of the strong economy and favorable market conditions and issued stock to raise capital.

[5] In July 2000, SEC employees voted to join the National Treasury Employees Union.

Figure 2: Number of Times Stock Market Trading Volume and the Value of IPOs Have Increased between 1980 and 2000

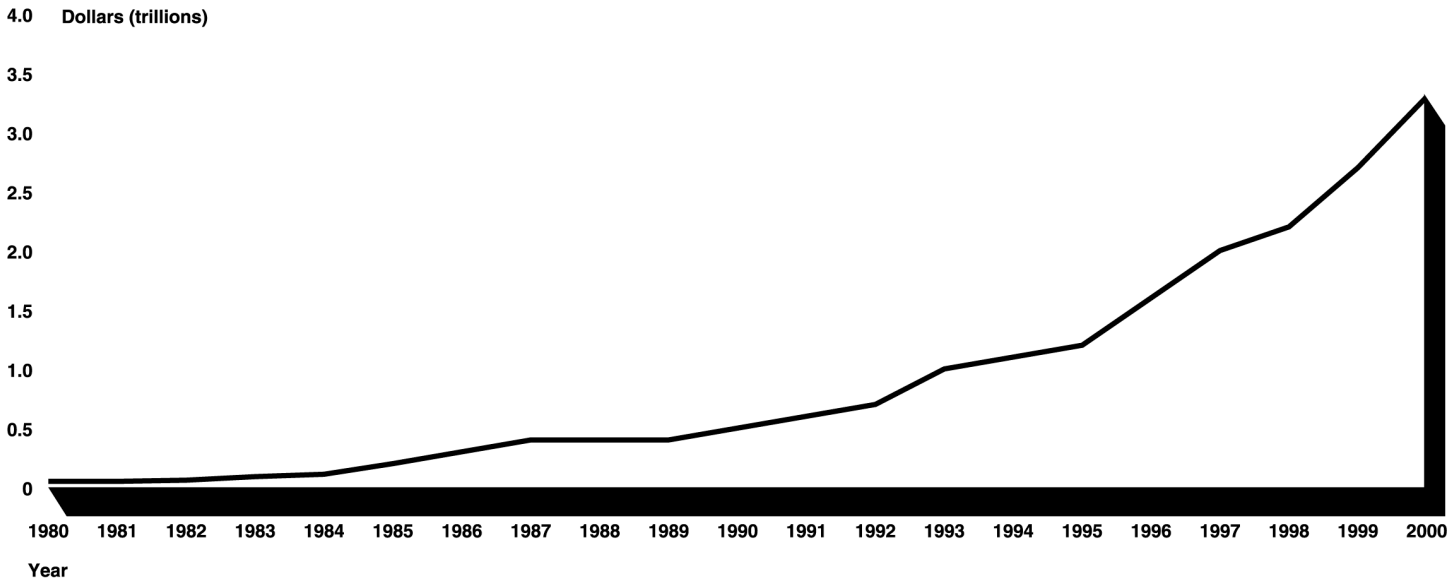


Source: GAO analysis of SEC data.

Likewise, in the 1990s many more individuals became investors by buying shares in mutual funds, further elevating the importance of SEC as a regulator. Figure 3 shows that the dollars that households had invested in mutual funds, excluding money market funds, grew from $46 billion in 1980 to $3.3 trillion in 2000. Moreover, as of December 2001, the total dollars invested[6] in mutual funds was almost $7 trillion, about twice the amount on deposit at commercial banks. This growth in amounts invested was due in part to higher stock values.

[6] Total dollars invested includes money market funds and funds owned by households; fiduciaries; and financial, business, and other organizations.

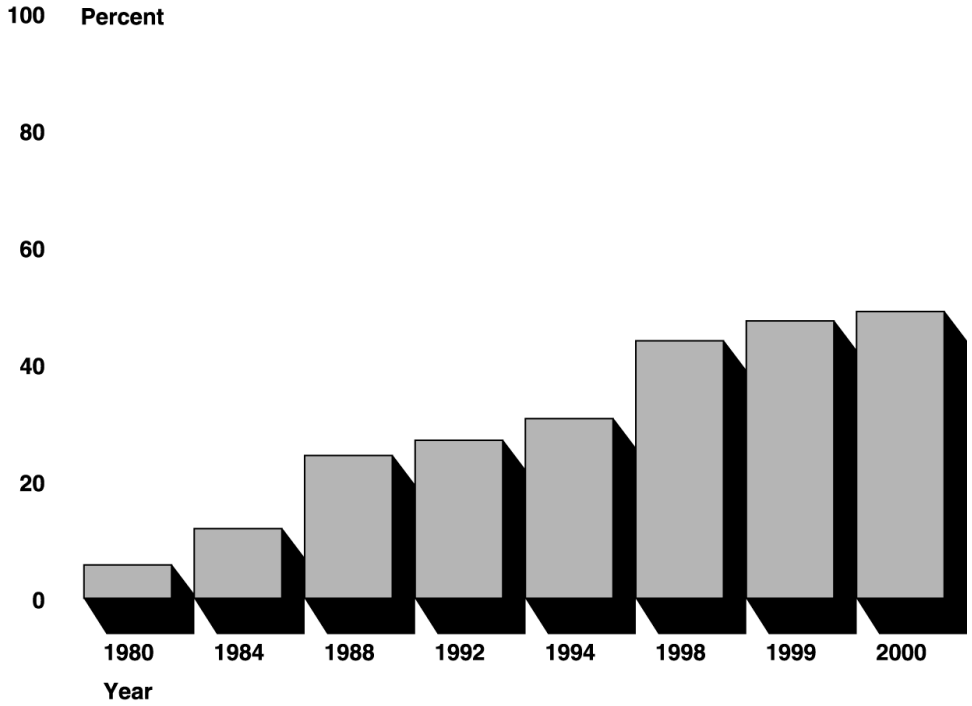
Figure 3: Growth in Dollars Households Invested in Funds, 1980-2000 (trillions of dollars)



Source: GAO analysis of SEC data.

Between 1980 and 2000, more households and individuals became investors in mutual funds and stocks. Figure 4 shows that the percent of U.S. households owning mutual funds also had increased to almost 50 percent of households by 2000. According to SEC, the number of households owning mutual funds in 2001 continued to increase with 52 percent of households owning funds. According to SEC, stock funds account for almost half of all mutual fund assets, and 75 percent of cash inflows to these funds come from retirement plans. Since 1990, the percent of U.S. retirement assets held in mutual funds has more than tripled. Moreover, according to New York Stock Exchange data, the number of individuals that owned shares of stocks increased 61 percent between 1989 and 1998.

Figure 4: Percent of U.S. Households Owning Mutual Funds, 1980-2000



Source: Investment Company Institute.

Securities Markets Have Become More Complex and International

Driven by technological advances, the securities markets have become more complex with an array of new products and market participants. Exchange-traded funds,[7] single-stock futures,[8] and on-line portfolios add to the products that SEC must oversee. Other technology-driven innovations such as ATSs, on-line brokerages, and day trading firms have also stretched SEC's regulatory capacity. For example, SEC regulates about 70 ATSs. Electronic communication networks (ECNs) ,[9] one type of ATS, account for about 30 percent of the daily share volume in Nasdaq

[7] An exchange-traded fund is type of investment company whose shares can be bought and sold on the secondary market, as well as from the investment company in large blocks of shares.

[8] A single-stock future is a contract to buy or sell a specific security at a particular price in a stipulated future month.

[9] An ECN is an electronic trading system that automatically matches buy and sell orders at specified prices. ECNs register with the SEC as broker-dealers.

securities. On-line brokerages, which were unknown a few years ago, are used by almost 12 million investors in making about 1.1 million trades per day. Likewise, investor protection concerns about day trading firms' activities resulted in greater regulatory activity in this area over the past few years.

New technology also has affected how the markets operate and how participants communicate. Stock exchanges and markets use complex electronic trading systems that SEC must understand and monitor. The Internet has allowed for rapid, widespread dissemination of information to investors, which also presents ongoing regulatory challenges to which SEC has been responding. For example, the Internet has provided simple, effective, and essentially anonymous ways for unscrupulous persons to exploit investors. As of May 2001, SEC had brought more than 240 Internet-related enforcements actions, charging close to 800 persons and entities with federal securities law violations.

The internationalization of securities markets also presents new challenges for SEC. In 1991, U.S. investors purchased and sold $949 billion in foreign securities. By 2000, that number had risen to $5.484 trillion—an increase of 478 percent. According to SEC documents, in 2001, approximately 130 foreign companies from 29 countries entered U.S. securities markets for the first time and filed over $312 billion in public offerings. In addition, over 1,300 foreign companies from over 59 countries filed periodic reports. SEC also recognizes the importance of being able to work closely with its international counterparts in enforcement and inspection activities, and to participate in international initiatives that relate to the supervision of global securities markets.

Legislative Changes Spur New Products and Regulatory Responsibilities

Legislative changes also created additional workload for SEC. For example, GLBA made SEC the primary regulator for all securities firms, including broker-dealers and investment advisers affiliated with financial holding companies.[10] While SEC has always coordinated with other financial regulators to a certain extent, GBLA requires that SEC undertake additional examinations and inspections of highly complex financial services firms, both to fulfill its own oversight responsibilities and to provide the Federal Reserve and other relevant agencies with the

[10] Before GLBA, most banks' brokerage and investment adviser activities were not subject to SEC regulation.

information and analyses to fulfill their missions. Likewise, the Commodity Futures Modernization Act of 2000, which allowed single-stock futures to trade in the United States, increases the number of potential regulated entities over which SEC has responsibility. It requires futures markets and certain futures commission merchants[11] to register with SEC as national securities exchanges and broker-dealers for the limited purpose of trading these products. In addition, the USA PATRIOT Act of 2001 assigned to SEC an expanded role in the fight against money laundering and terrorism. SEC is working with the Department of Treasury on rulemakings related to shell banks, customer identification, suspicious activity reporting, and correspondent and private banking, as well as studies on managed funds and the overall operation of the legislation. SEC has expanded examination responsibilities for broker-dealer compliance under the Bank Secrecy Act and new examination responsibilities for other financial institutions regulated by SEC, including investment companies.

SEC's Ability to Fulfill Its Mission Has Become Increasingly Strained

SEC and industry officials said SEC's ability to fulfill its mission has become increasingly strained due in part to imbalances between SEC's workload (e.g., filings, complaints, inquiries, investigations, examinations, and inspections) and staff resources.[12] As figure 5 illustrates, since 1996 SEC's staff resources have not grown commensurate with its workload.[13] Although industry officials complimented SEC's regulation of the industry given its staff size and budget, both SEC and industry officials identified several challenges SEC faces. First, resource constraints have contributed to substantial delays in the turnaround time for many SEC regulatory and oversight activities, such as approvals for rule filings and exemptive applications.[14] Second, SEC's resource constraints contributed to bottlenecks in the examination and inspection area as workload grew. Third, limited resources have forced SEC to be selective in its enforcement activities and have lengthened the time required to complete certain

[11] Futures commission merchants are firms that buy and sell futures contracts as agents for customers.

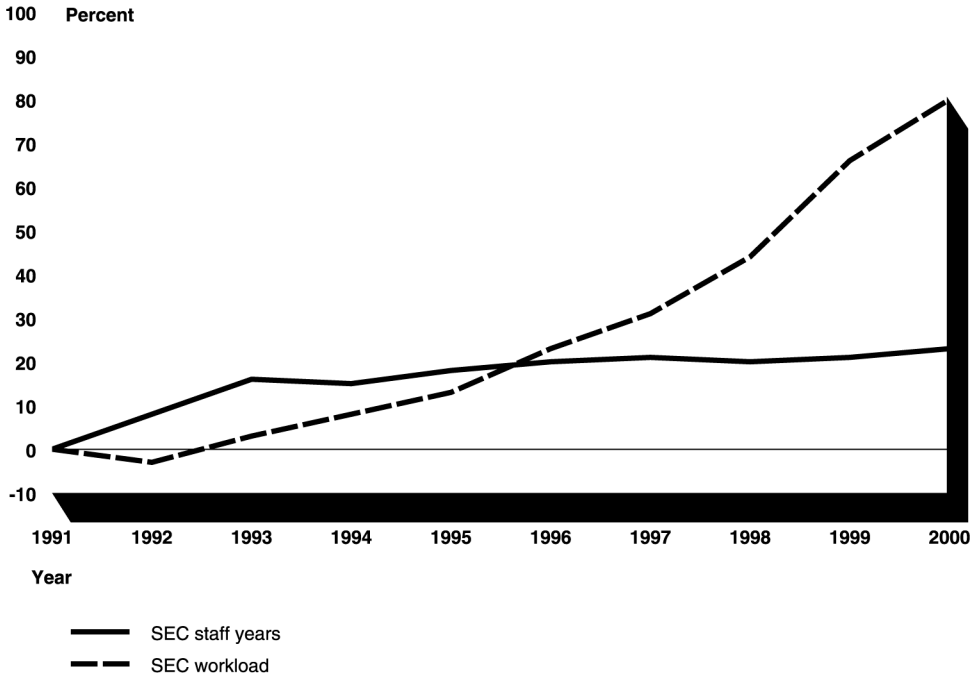
[12] Staff resources are measured in this report in terms of full-time equivalent staff years.

[13] Information presented throughout this report on SEC's staffing, resources, budget, and other operations relates to fiscal years.

[14] A company files an exemptive application when it seeks an SEC decision to exempt a new activity from existing rules and laws.

enforcement investigations.[15] Fourth, certain filings were subject to less frequent and less complete reviews as workloads increased. Fifth, today's technology-driven markets have created ongoing budgetary and staff challenges. Finally, SEC and industry officials said that SEC has been increasingly challenged in addressing emerging issues, such as the ongoing internationalization of securities markets and technology-driven innovations like ATSs and exchange-traded funds.

Figure 5: Percent Change in SEC Staff Years and Workload from 1991 to 2000



Source: GAO analysis of SEC data.

[15] The SEC chairman has recently announced an initiative called real-time enforcement, which is intended to protect investors by: (1) obtaining emergency relief in federal court to stop illegal conduct expeditiously; (2) filing enforcement actions more quickly, thereby compelling disclosure of questionable conduct so that the public can make informed investment decisions; and (3) deterring future misconduct through imposing swift and stiff sanctions on those who commit egregious frauds, repeatedly abuse investor trust, or attempt to impede SEC's investigatory processes. According to SEC, insufficient resources may inhibit the effectiveness of this initiative, which depends upon prompt action by enforcement staff.

SEC Resource Levels Have Not Grown Commensurate with Its Workload

Although there may not be a need for an identical offsetting increase in SEC staff compared to the increases in its workload, larger, more active, and more complex markets have produced more market participants, registrants, filings, examinations and inspections, legal interpretations, complaints, and opportunities for fraudulent activity. Over the last decade, staffing, within different areas of SEC's regulatory oversight activities, has grown between 9 and 166 percent, while workload measures in those areas have grown from 60 to 264 percent. As figure 6 illustrates, the increases in SEC's workload substantially outpaced the increases in SEC's staff. For example, the number of corporate filings increased 60 percent, while related review staff increased 29 percent. This figure also shows that the number of complaints and inquiries received increased by 100 percent, while the enforcement staff dedicated to investigate complaints and other matters increased by 16 percent.[16] In addition, the number of market and firm supervision actions increased 137 percent, but the number of staff responsible for these activities increased 51 percent. Market and firm supervision actions include

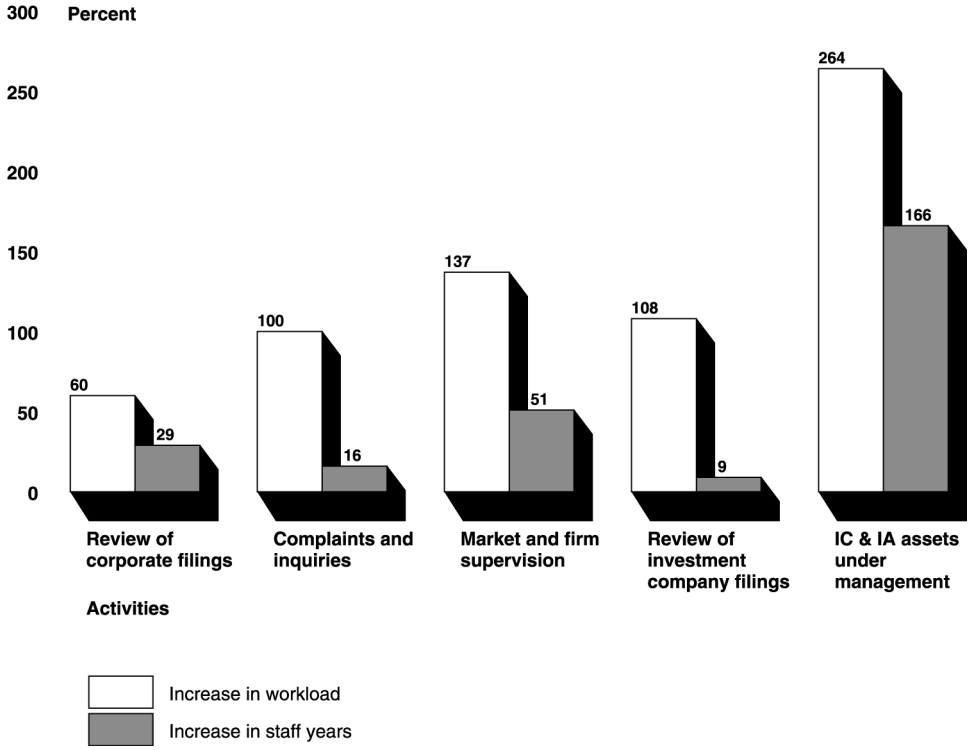
- SRO[17] and SEC rule proposals;
- interpretive guidance and exemptive applications;
- analyses of proposed enforcement actions, disclosure documents, and risk assessment reports;
- automated trading system analyses and automation reviews of SRO systems;
- policy papers;
- Congressional, governmental, industry, and public correspondence; and
- other reports and analyses of SEC's Division of Market Regulation.

Investment company filings increased 108 percent while staff increased 9 percent. Likewise, total assets under management by investment companies (IC) and investment advisers (IA) increased by about 264 percent over 10 years, while the number of IC and IA examination staff increased by 166 percent.

[16] Although complaints are not a comprehensive measure to compare with the level of investigative resources, many enforcement actions are initiated based on complaints received by SEC. Investigations might also be started, for example, from SEC inspections and examinations or matters referred to SEC by SROs or state regulators.

[17] SROs are organizations responsible for regulation of member broker-dealers.

Figure 6: Percent Change in Workload and Staff Years for Selected SEC Activities



Source: GAO analysis of SEC data.

Substantial Delays Exist in the Completion of Many Regulatory and Oversight Activities

The imbalance between workload and resources has resulted in SEC taking longer to process various types of filings, issue guidance, and review applications. Although SEC did not provide statistics on the time frames to process its workload, various industry officials told us they have to wait longer to receive SEC's response to their filings and applications. They said that SRO rule filings take longer to get approved as SEC's workload has increased. Likewise, the officials said that the amount of time SEC takes to process interpretive guidance and no-action letters[18] has increased, as has the length of time taken to process exemptive applications. Finally, the amount of time taken to review IPOs filings had also increased. The officials said these delays could affect industry competition and efficiency.

[18] A company would seek a no-action letter from SEC when it plans to act in a new or unclear area.

Backlog of SRO Rule Filings Has Grown

According to SEC officials, a growing backlog of SRO rule filings resulted in delays in responding to filings. As of January 2002, SEC officials said that there were 284 SRO rule proposals in the pipeline. The officials said that because of the high staff turnover in recent years, SEC did not have enough seasoned staff available to process the rule proposals more quickly. SEC data shows that the number of rule filings open at year-end increased 40 percent from 174 in 1998 to 243 in 2001. Also, SEC expects the number of SRO rule filings to continue to increase because of registration of new exchanges and the implementation of additional oversight responsibilities for exchanges trading single-stock futures. In 2001, SEC received 638 proposed rule changes compared to 444 in 1991—a 44 percent increase. Industry officials believed resource constraints were one reason that SEC now takes longer to complete these reviews than in the past. Such delays can have important affects on those making the filings. For example, an SRO official said that when SEC takes a year or more to approve a proposed change, the SRO can lose the competitive advantage from making the change. Although SEC officials said that they do not keep statistics on the length of time it takes to review filings, other industry officials said that they have waited months with no response from SEC.

In addition to approving SRO rule filings, SEC also develops its own rules. For example, in 2001, SEC developed 74 rule proposals and interpretive releases. One rule proposal SEC is considering would improve the SRO rule proposal review process. To address many of the concerns mentioned previously, the proposed Rule 19b-6 would, among other things, require SEC to (1) issue a release relating to filed proposed rule changes within 10 business days of receipt of the filing, (2) eliminate the pre-filing requirement and the 30-day delayed operational period before which noncontroversial rule changes can be filed or become operative, (3) expand the categories of proposed rule changes that qualify for immediate effectiveness to include certain trading rules, and (4) permit SROs to file proposed rule changes electronically. According to SEC staff, the initial rule proposal that was released over a year ago, in January 2001, was considered to be controversial. For example, some of the exchanges did not think the proposal went far enough in streamlining the rule filing process, while many broker-dealers were concerned about reduced SEC oversight. SEC is still considering comments it received from the industry and has not decided on the final contents of the rule.

Staff Constraints Result in Delays in Guidance

In addition to reviewing and approving SRO rule filings, SEC provides guidance to registrants, prospective registrants, and the public to help them comply with securities laws. This usually takes the form of

interpretive guidance and no-action letters, and each year SEC processes hundreds of these requests. Industry officials said that they have to wait longer to obtain SEC guidance in the form of no-action letters and interpretive guidance than in past years. SEC officials said that there were numerous no-action letters and interpretive guidance in process. In 2001, SEC processed over 1,600 requests for guidance from securities firms, investment companies, and investment advisors, which increased from about 1,360 in 1991. SEC staff also said that, as of January 2002, the chairman was reviewing SEC's interpretive guidance process. Industry officials said that delays in obtaining SEC guidance can create legal uncertainties and stifle innovation. In the future, although staff levels are expected to remain static, SEC expects its workload in this area to increase as more firms request guidance on how SEC's financial responsibility and investor protection rules apply to securities firms that become part of large financial services organizations and enter into increasingly complex financial transactions.

SEC Also Takes Longer to Review Exemptive Applications

SEC's processing of exemptive applications has also experienced delays. SEC is responsible for processing applications for exemptive relief from various statutory provisions and rules. The Investment Company and the Investment Adviser Acts authorize SEC to exempt any person, security, or transaction from one or more provisions of the acts. Exemptive applications usually take about 3 to 6 months to process but as the issues involved become increasingly complex it can take much longer. A 1996 SEC inspector general (IG) report[19] noted that it was not unusual for the length of time required for staff review to be a year or longer due to the complexity of the issues, the lack of delegated authority, or workload pressures.[20] Industry officials said that the time that SEC takes to approve exemptive applications has continued to increase and that inadequate staffing was part of the problem. For example, in the more extreme cases, an official said that SEC took over 1 year to process "a relatively routine" exemptive application and over 5 years to render a decision on another application. The IG also found that to avoid lengthy delays some firms abandoned plans that require exemptive relief or altered them to adopt a less innovative approach that did not require filing for an exemption.

[19]U.S. Securities and Exchange Commission, Inspector General, *Applications for Exemptive Relief*, Audit Report No. 230 (Washington, D. C.: March 1996).

[20] SEC is required to publish notice in the *Federal Register* of proposed exemptions giving interested parties the opportunity to request a hearing before a final exemptive order is issued. The notice period typically is 25 days.

Industry officials we spoke with also said that these delays stifled innovation and hampered competition.

SEC Reviews of IPO Filings Can Be Lengthy

Industry officials also said that the time SEC takes to approve IPOs has grown. Although the number of IPOs has decreased substantially in the past 2 years, industry officials continued to cite this as a challenge for SEC albeit a less pressing one. In 2001, SEC completed 745 IPO issuer reviews, down from 1,350 in 2000. SEC said that IPOs are a priority and that every IPO gets a full review. Industry officials said that it generally takes SEC 4 to 7 weeks to complete the review process, but the officials added that they see no reason that the process should take that long. These officials also said that the industry perception is that SEC's existing staffing level is insufficient given its workload. The length of time it takes to review an IPO has economic implications for the issuing company because market conditions can change (e.g., the estimated value of the stock can fall in adverse market conditions), thereby increasing the cost of the IPO or making the IPO not feasible. Moreover, the officials said that lengthy delays in the completion of IPO filings can increase the likelihood that issuers may opt for private placements or go offshore even if it is more costly. They also said that lengthy delays may discourage foreign companies from entering U.S. markets.

Workload Adversely Affects SEC Examination and Inspection Function

The increasing complexity and growth of the capital markets has also affected SEC's ability to inspect and examine the operations of various regulated entities. Each year, SEC usually conducts from 800 to 900 inspections and examinations of SROs, broker-dealers (including their branch offices and registered representatives), transfer agents, and clearing agents for compliance with the federal securities laws and regulations. To better utilize its resources, in the mid-1990s the Office of Compliance Inspections and Examinations (OCIE) began conducting fewer full scope examinations, which review all aspects of operations, and more frequent risk-based examinations, which focus on specific areas or issues.

Although staff levels are expected to remain unchanged in 2003, SEC expects the number of larger, more complex brokerage firms and other financial institutions to grow. SEC also expects to enhance its internal control examination program. These internal control examinations usually

take longer to complete and require special training and skills.[21] In 2001, SEC said that they conducted about 22 to 25 broker-dealer internal control examinations compared to 1 to 3 when they started the program in 1995. However, with no increase in staffing SEC may find it difficult to continue to increase the number of internal control examinations completed.

Although SEC officials said that they had been able to maintain their examination schedules and workload with their existing staff levels, some officials were concerned that the cycle for certain types of reviews could stretch beyond the planned time frames. For example, some officials said that the investment adviser reviews could stretch beyond the existing 5-year cycle in the future, if that examination program does not have sufficient resources. They added that a minimum review 1 in every 5 years was vital to the level of oversight needed to protect investors. SEC officials also said that new rules that have been implemented will add time and complexity to the reviews. Overall, SEC officials said that OCIE had lost a lot of experienced staff at the junior level and that new staff requires constant training.

Several industry officials also said that the time between the completion of SRO inspections and the issuance of final inspection reports is lengthy. SRO officials said that after an inspection is done it usually takes a year or two before the report is final. Some SRO officials said that the lag between the completion of the inspection and the issuance of the report could result in findings and recommendations becoming obsolete because the recommended changes had already been made or programs revised. These officials said that they would prefer to have the problem pointed out during the inspection process so as not to delay any necessary corrective action. Such lags in the inspection process can cause inefficiencies in SROs' operations.

According to SEC officials, other factors, in addition to resource constraints, also contribute to the extended time required to complete SRO inspections. SRO inspection reports require a more extensive level of review due to the variety of complex issues relating to SROs. Moreover, any recommendations must receive higher scrutiny because they could potentially impact SRO members. However, SEC officials said they recognize this is an issue and that steps are being taken to improve the

[21] Internal control examinations are intense reviews of internal controls relating to trading, liquidity, credit, new products, and other aspects of broker-dealer operations.

inspection process. For example, SEC plans to provide more detailed information about preliminary findings at exit interviews and inform SROs sooner about the issues that will likely be addressed in the final inspection reports. They also said that they plan to do more risk-based inspections of SROs.

Workload Growth and Limited Staffing Raise Concerns about Enforcement

SEC and industry officials said that delays in closing cases and a backlog of smaller investigations presented ongoing challenges for SEC. Between 1991 and 2000, Division of Enforcement staff devoted to investigations increased 16 percent, from 414 to 482 staff years, while the number of cases opened increased 65 percent, from 338 to 558. Although increased staff has allowed more work to be initiated, delays in completion of individual cases persist. Moreover, the number of cases pending at the end of the year increased 77 percent, from 1,264 in 1991 to 2,240 in 2000. SEC officials said the increase in cases pending was partly attributable to high staff turnover, which has resulted in old cases not being closed or ongoing cases being delayed until other staff can take over. The officials said that in 2000, 58 experienced staff left the division.

SEC and industry officials said that SEC's enforcement activities are important for carrying out SEC's mandate to protect investors and deter fraud and abuse. SEC officials said that they cannot prosecute every case and, therefore, must prioritize the cases they will pursue. SEC officials said they recognize that they have limited resources and operate accordingly. According to SEC officials, SEC generally prioritizes the cases in terms of (1) the message delivered to the industry and public about the reach of SEC's enforcement efforts, (2) the amount of investor harm done, (3) the deterrent value of the action, and (4) SEC's visibility in certain areas such as insider trading and financial fraud. Except for the length of time taken to complete an investigation, most officials said that SEC was effective in this area. Although SEC data show that the average length of time to complete an investigation decreased, we did not perform a detailed review of the individual investigations to determine whether this was an improvement or whether SEC on average pursued less time-consuming matters for investigation.

SEC Information Technology Systems and Funding Gaps Contribute to Inefficiencies

SEC and industry officials agree that SEC has improved its technological capabilities and expertise and has been proactive in creating innovative systems that assist the industry. However, SEC officials said that additional money is needed to improve the usefulness of many of its systems and to increase the technical knowledge of SEC staff. EDGAR[22] and the investment adviser registration depository (IARD) [23] systems were created to provide electronic collection, storage, and retrieval of data for the industry and investors. However, SEC staff and industry participants said that these systems provide limited capability to retrieve information. Currently, users can retrieve corporate and financial information from EDGAR, but the system is unable to generate trend information. SEC officials said that they must obtain this information from outside sources. An SEC staff member noted that the IARD system could be upgraded to include a variety of functions beyond storing investment adviser information including a search capability that identifies advisers according to state and specialty. However, the officials said that SEC was only allocated enough funds to meet the requirement of providing investors with a readily accessible database of information about investment advisers and persons associated with investment advisers. It did not receive sufficient funding to make the system fully useful for regulatory oversight or as an analytical tool.

According to SEC officials, SEC's 2002 information technology budget of $46.6 million was used primarily for hardware and software maintenance and technology infrastructure needs. These officials said that they requested, but did not receive, additional funding for capital improvements such as a nationwide network to support the examination and inspection activities and enhancements to the IARD. According to the officials, SEC has a list of technological improvement projects that have not been funded due to budgetary constraints. Several SEC officials said that requests have included applications that allow for better manipulation and connectivity of various SEC data systems and computerized reports. For example, one SEC official said that he must wait days for market surveillance data to be downloaded, even though technology exists that would allow SEC to obtain this information in seconds. The officials said that SEC's technology needs vary from having a simple toll-free number for investors

[22] EDGAR is a database system through which public companies electronically file registration statements, periodic reports, and other forms to SEC. Anyone can access and download EDGAR information for free.

[23] IARD is the system that investment advisers must use to register with SEC.

to contact SEC staff to having the capability to reconstruct trading activity in case of a major market failure, such as the 1987 market break.

SEC and the industry also cited the lack of additional technical staff as another issue. Some SEC officials said that they would like to have more information technology specialists to participate in certain examinations. One official said that SEC needs more technical specialists to evaluate industry participants' computer and information systems and to ensure compliance with new privacy laws that protect investor information and assets. As of January 2002, SEC had only two examination staff dedicated to technology issues involving broker-dealers and other non-SRO examinations.

SEC requested an additional $13 million in its 2003 budget authorization request to support the agency's information technology and automation efforts. Such funding was necessary to enable SEC to

- respond to federal requirements to expand electronic interactions with filers, registrants, the public, and other external customers;
- enhance SEC's examination and inspection program by providing automated tools to analyze large information databases used by investment advisers;
- upgrade the database, which is used in its investigative process to search and match lists of names received from other agencies;
- respond to federal requirements to ensure information security with better intrusion-detection capabilities and incident responsiveness and provide additional information security awareness training; and
- obtain the necessary hardware for creation of a "virtual private network" that will allow secure access for offsite inspection and examination activities.

SEC's oversight of SRO information systems is conducted through SEC's Automation Review Policy (ARP) program,[24] which in mid-2001 was administered by 10 staff members in the Office of Technology and Enforcement within the Division of Market Regulation. GAO reported in July 2001 that SEC's ability to oversee information system issues was hampered by the limited resources available to the ARP program, a factor

[24] ARP is a program under which SROs agree to submit to SEC oversight of their information systems.

that also constrained its staffs' ability to inspect the SRO's automated systems on a timely basis.[25]

Industry officials were not impressed by SEC's technology oversight. One industry official described SEC's technology reviews as fairly basic. Another industry official said that SEC staff had limited technical knowledge. This knowledge is vital for overseeing transaction systems including settlement and trading systems. And yet another industry official highlighted a "lack of confidence" in SEC's ability to effectively review technology and related capacity issues. SEC officials said that SEC has made improvement over the last several years and has tried to stay abreast of technological advances, but like most regulators SEC remains behind market developments.

Certain Financial Statement and Other Filings Are Subject to Less Frequent Review by SEC Staff

The number of corporate filings SEC received increased 59 percent from 61,925 in 1991 to 98,745 in 2000. The increase was primarily due to the tremendous increase in the number of IPOs and other market transactions filed with SEC. During this same time period, the staff years devoted to the review of these filings, primarily for accountants and attorneys, increased 29 percent from 125 in 1991 to161 in 2000. SEC officials said that this limited staff growth combined with the high volume of IPOs limited SEC's ability to review other filings, which also increased. The officials said that staff perform full reviews[26] of all registration statements for IPOs and may review other transactional filings related to raising capital or mergers and acquisitions. As a result, fewer resources are available to review the annual and quarterly filings of previously registered securities issuers. The percent of all corporate filings that received a full review, a full financial review, or were just monitored for specific disclosure items decreased from about 21 percent in 1991 when 13,198 were reviewed to about 8 percent in 2000 when 8,498 were reviewed.

[25] U.S. General Accounting Office, *Information Systems: Opportunities Exist to Strengthen SEC's Oversight of Capacity and Security*, GAO-01-863 (Washington, D.C.: July 25, 2001).

[26] SEC's review of corporate filings may involve a full review, a full financial review, or certain filings may be monitored for specific disclosure items. A full review involves an in-depth examination of the accounting, financial, and legal aspects of an issuer's filing. A full financial review involves an in-depth accounting analysis of an issuer's financial statements and management's discussion and analysis or business plan disclosure.

According to SEC officials, until the early 1980s, SEC completed full reviews of all transactional filings. The officials said that approach would not be possible in today's market without a substantial increase in staff resources. In addition, SEC's goal was to complete a full financial review of each issuer's annual filings in at least 1 of every 3 years—a review goal of about 30 to 35 percent of annual filings per year. According to SEC, this proposed level of review was expected to "ensure that material issues are disclosed clearly and completely and that possible fraudulent activities are addressed promptly." However, in 2001, SEC completed full or full financial reviews of about 16 percent, or 2,280 of 14,060 annual reports filed.

In November 2001, the Division of Corporation Finance announced that staffing levels were expected to remain flat while filings were expected to continue to increase and be more complex. In this post-Enron environment, SEC plans to reconsider its approach to determining how it will select filings for review and how it will review the filings selected. Rather than conducting full reviews of fewer firms, the officials said SEC may limit its review to a specific disclosure issue and review more filings for that issue. For example, SEC may choose to focus on off-balance sheet activities and work with the company to improve disclosure. However, the officials said that full reviews will not be completely abandoned, but the revised approach should help SEC better deploy limited staff resources and enable it to have a greater review presence across all types of corporate filings in the future. Further, in December 2001, in response to the disclosure and accounting problems of Enron Corporation, SEC said that it began reviewing the annual filings of the 500 largest U.S. companies.

SEC also reviews investment company filings, such as mutual fund prospectuses for compliance with disclosure requirements. As previously shown in figure 6, the number of investment company filings more than doubled from 17,143 in 1991 to 35,686 in 2000, while staffing for that activity increased by only 9 percent from 45 staff years in 1991 to 49 in 2000. However, the staff reviewed 33 percent of investment company filings in 1991 and increased that rate to 49 percent in 2000. SEC officials said the increase in the percentage of filings reviewed was due partly to changes in the types of filings coming into the agency, and partly to the fact that certain filings were counted as reviewed even though all aspects of the filings were not always fully reviewed. For example, if a mutual fund company introduces several new stock funds, only one of the new funds may be given a full review, and only the unique aspects of the other funds may be reviewed.

SEC Is Not Addressing Many Current and Evolving Issues

Both SEC and industry officials agree that the current level of human capital and budgetary resources has strained SEC's capacity to address current and evolving market issues. Industry officials generally hold SEC staff in high regard and said that SEC does a good job overall. However, industry officials also said that they would like to see SEC devote more effort to evolving and ongoing areas such as global market issues, technology, ATSs, financial statement reporting, and the net capital rule.[27] For example, one industry official said that SEC should be more proactive in coordinating with other regulators and industry in dealing with these issues. The official noted that SEC's reliance on a small number of seasoned staff to do the majority of the routine work does not allow those staff to adequately deal with new and emerging issues. For example, this official and others said that SEC needs to overhaul its approach to net capital to make use of modern risk management techniques. They said that SEC could benefit from hiring more financial economists to assist in this effort. They said that the current net capital rule imposes unnecessary costs on broker-dealers that deal in multiple products.

According to SEC officials, SEC lacks resources to deal with an increasing workload, review new products, and implement needed changes to rulemaking and policy interpretations. For example, one SEC official said that additional resources would be needed for SEC to review new products, like exchange-traded funds, and still be able to address its traditional workload. Likewise, recent high-profile accounting scandals, such as that involving Enron Corporation, have raised questions about SEC's ability to monitor disclosure requirements, which is vital to its goal of protecting investors.

Other Factors Contribute to the Challenges Facing SEC

In addition to the staff and workload imbalances, other factors also contribute to the challenges SEC currently faces. SEC officials said that, although additional resources could help SEC do more, additional resources alone would not help SEC to address its high staff turnover, which continues to be a problem. Furthermore, in recent years the staff turnover and large differentials in pay between SEC and other financial regulators and industry employers resulted in many staff positions remaining vacant as staff left at a faster rate than officials could hire new staff. Although SEC now has the authority to provide pay parity,

[27] The net capital rule, SEC Rule 15c3-1, is a liquidity standard that requires broker-dealers to (1) maintain a minimum level of liquid capital sufficient to promptly satisfy all of its obligations to customers and other market participants and (2) provide a cushion of liquid assets to cover potential market, credit, and other risks.

implementing it will depend upon SEC receiving sufficient budgetary resources. Industry officials also said that existing securities laws, which require SEC to approve market innovations and changes before they can be introduced into the market, can create a regulatory bottleneck. Industry officials said that there are steps SEC could take to avoid these bottlenecks and work more efficiently and effectively, such as by reforming its regulatory approval processes. Finally, we found that SEC's budget and strategic planning processes could be improved to better enable SEC to determine the resources needed to fulfill its mission. For example, unlike "high performing organizations," SEC has not systematically utilized its strategic planning process to ensure (1) that resources are best used to accomplish its basic statutorily mandated duties and (2) that human capital planning addresses the resource needs that are necessary to fulfill the full scope of its mission, including activities to address emerging issues.[28]

SEC and Industry Officials Cite Turnover as a Primary Challenge

As we noted in our 2001 report on SEC's human capital practices, about one-third of SEC's staff left the agency from 1998 to 2000.[29] SEC's turnover rate for attorneys, accountants, and examiners averaged 15 percent in 2000, more than twice the rate for comparable positions governmentwide. Although the rate had decreased to 9 percent in 2001, turnover at SEC was still almost twice as high as the rate governmentwide. Further, as a result of this turnover and inability to hire qualified staff quickly enough, about 250 positions remained unfilled in September 2001. SEC officials said that they could do more if they had more staff, but all cited SEC's high turnover rate as a major challenge in managing its workload. Likewise, industry officials agreed that many of the challenges SEC faces today are exacerbated by its high turnover rate, which results in more inexperienced staff and slower, often less efficient, regulatory processes.

From the industry's perspective, SEC's high turnover and resulting staff inexperience has contributed to many of the delays and problems discussed in the previous section. Industry officials said that, in the examination area, staff inexperience sometimes resulted in examinations taking longer to complete or focusing on procedural violations rather than

[28] High performing organizations are organizations that have been recognized in the current literature or by GAO as being innovative or effective in strategically managing their human capital.

[29] GAO-01-947.

substantive ones. At the beginning of 2000, 76 percent of examiners had worked at SEC fewer than 3 years. Likewise, from 1992 to 1999, the average tenure of an examiner declined from 2.9 to 1.9 years. SEC officials also told us that high staff turnover contributed to the delays in rulemaking and regulatory guidance discussed earlier. For example, SEC officials said that SEC has had problems retaining senior market supervision staff and that junior staff, on average, stay only for two years. In 1992, the average tenure for attorneys leaving SEC was 3.4 years, by 1999 the average had declined to 2.5 years. The officials said that this has contributed to the backlog in the SEC's rulemaking, interpretive guidance, and other activities. The officials also said that they have to constantly focus on current priorities, while other work gets put aside.

Although SEC and industry officials said that SEC would always have a certain amount of turnover because staff can significantly increase their salaries in the private sector, many said pay parity with other financial regulators could enable SEC to attract and retain staff for a few additional years. SEC estimated that a new employee generally takes about 2 years to become fully productive, and that pay parity could help them keep staff a year or two beyond the initial 2 years. Although industry officials said they were generally impressed by the caliber of staff that SEC hires and the amount of work they do, they said that staff inexperience often requires senior officials to become more involved in basic activities. Industry officials also said that certain divisions, such as the Division of Market Regulation, could benefit from more staff with a fundamental understanding of both how markets work and market experience. They said that such experience could help speed rulemaking and review processes. According to SEC, the Division of Market Regulation over the past two years hired six attorney "fellows"[30] with considerable industry experience. However, one attorney fellow recently informed the division that he will be leaving the program because of the failure to implement pay parity. SEC officials said that they have a difficult time attracting staff with market experience, given the government's pay structure.

Some officials said that SEC's turnover rate should decrease after pay parity is implemented. Presently, SEC professional staff are paid according to government pay rates. On January 16, 2002, the president of the United

[30] Like SEC's Office of the Chief Accountant, Market Regulation has a fellows program to attract seasoned attorneys. According to SEC officials, twenty percent of the division's GS-15 attorneys are attorney fellows.

States signed legislation that exempted SEC from federal pay restrictions and provided it with the authority necessary to bring salaries in line with those of other federal financial regulators. Although SEC now has the authority to implement pay parity, as of March 1, 2002, SEC has not received an additional appropriation to fund its implementation. In February 2002, SEC's chairman wrote to the chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, that SEC urgently needed pay parity and, that since the legislation had passed and become law, any decision not to support funding for pay parity would exacerbate the staffing problems it was intended to cure. The chairman also advised that SEC could "face even greater employee losses and suffer greater irreparable harm to morale" if pay parity was not funded. Therefore, it is too soon to determine the effect, if any, of pay parity on SEC's ability to attract and retain staff.

Industry Cites Challenges Posed by the Securities Laws

In addition to turnover, industry officials said that provisions in securities laws, which require upfront approvals, determine the pace at which SEC can approve market innovations the participants want to implement. For example, the Securities Act of 1933 and the Securities Exchange Act of 1934 generally require SEC to approve certain new products or market innovations prior to their implementation. Unlike banking regulators, who generally allow banks to engage in various banking-related financial activities unless they are specifically prohibited by statute, SEC must approve many new products before they can be introduced into the market. The securities laws also require SEC approval of new activities before market participants can adopt them. For example, SEC must approve exemptive applications that are filed by investment companies to engage in activities that may be prohibited by statute. However, as the number of these applications filed increases and the activities become more complex, SEC may be able to close fewer applications each year, and the time taken to close the applications may increase. As a result, registrants are unable to engage in certain activities until SEC approves them, which may put them at a competitive disadvantage. Although an in-depth analysis of this issue was beyond the scope of this report, some industry officials questioned whether the cost of delaying potentially useful products from entering the market outweighed the benefit of blocking a few harmful products.

Like any regulatory structure, provisions of these laws present advantages and disadvantages. First, the provisions enable SEC to prohibit new products or actions by industry participants that SEC believes to be harmful. Yet, SEC faces the difficult task of trying to evaluate the risks of

products that are untested in the market. Conversely, the provisions can also stifle innovations and advances in the market if the review process is cumbersome. Some officials said that it would be a more efficient use of SEC resources if SEC were able to focus on oversight instead of advanced approvals when the exemptive applications, or proposed rule filings, would have no adverse competitive effects on other market participants. However, SEC officials said that if new products and innovations were no longer subject to review and approval before their introduction, SEC would need significantly more examiners to monitor the new products and innovations after they were introduced.

SEC's Could Improve Its Budget Planning Process

Although SEC annually participates in the federal budget process, SEC has not reviewed its staffing and resource needs independent of the budget process. That is, SEC generally develops its annual budget request based on the previous year's appropriation, not on what it actually would need to fulfill its mission. Although SEC officials said that they can shift staff from one area to another to address new priorities, SEC's reactive approach can result in regulatory gaps. Comprehensive strategic planning that relates SEC's resource needs to its ability to fulfill its mission could help SEC better identify and manage resource needs.

SEC's Budget Process Begins with the Past Year as a Base

SEC officials said that the annual budget cycle begins with the preparation of an agency-wide estimate based on the previous budget year's appropriation. Next, SEC develops a conforming budget estimate based on the budget guidance, including a specified budget amount that the Office of Management and Budget (OMB) provides to SEC. SEC budget staff then asks officials from each of SEC's divisions and offices to review and update program information and provide estimates of their resource needs. However, the division and office officials said that they are often told how much of an increase they can request in order to be consistent with the budget guidance. The budget staff coordinates the requests and discusses staffing needs with the division and office officials. SEC's proposed budget estimate is then sent to OMB, and a budget hearing is subsequently held. During the hearing, any policy changes or shifts in the SEC chairman's priorities are discussed. SEC's budget estimate is incorporated into the president's budget, which is presented to Congress. However, before the budget is final, SEC has the opportunity to appeal to OMB to modify its approved funding level. SEC's funding level is also

subject to congressional review and appropriation before it becomes final.[31]

In addition to its budgeted funding level, SEC also has a "no-year account," which consists of certain fees collected and funds that have been appropriated over the years but not expended by year-end. SEC, like several other agencies, is allowed to keep appropriated funds that are not expended at the end of the year.[32] Money in this fund is generally used for one-time expenditures that are not included in the annual budget. SEC officials said SEC can use funds from the no-year account after OMB and Congress approve these expenditures. SEC officials said that money from the no-year account was used to pay expenses incurred to reopen SEC's Northeast Regional Office, which was located at 7 World Trade Center, following September 11th.[33] SEC also used money from the no-year account to modernize its EDGAR system. Although SEC had over $75 million in its no-year account in fiscal year 2001, SEC officials said that Congress rescinded $50 million from the no-year account as part of SEC's 2002 appropriation. As of the beginning of fiscal year 2002, SEC had about $25 million in its no-year account.

Similar to banking regulators collecting assessments and fees from banks, SEC collects fees on registrations, certain securities transactions, and other filings and reports. However, unlike the banking regulators, which are self-funded, SEC deposits its collections in an SEC-designated account at the U.S. Treasury that is used by SEC's congressional appropriators for, among other things, providing appropriations to SEC.[34] Public Law 107-123, which authorized pay parity for SEC, also amended the Securities Act of 1933, the Securities Exchange Act of 1934, and the Trust Indenture Act of 1939 to reduce the fees collected by SEC while providing a stable long-

[31] Separate from this process, SEC also prepares a budget authorization request that gives it a greater opportunity to independently determine its needs and make a corresponding request, which is submitted to SEC's congressional oversight committees.

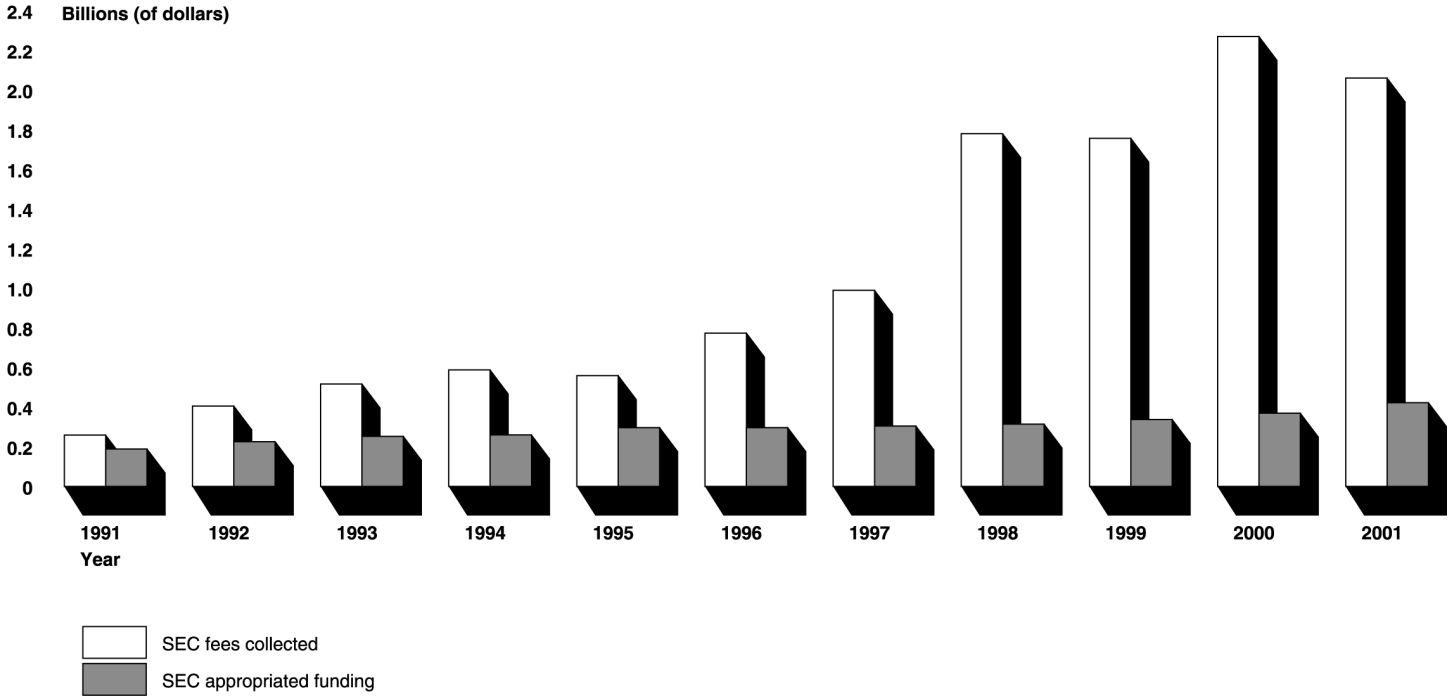
[32] The Departments of Commerce, Justice, State, and the Judiciary, for example, are also able to keep unspent funds.

[33] SEC was subsequently reimbursed for the expenses it incurred as a result of the attacks.

[34] Federal banking regulators, like the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency are self-funded and are not subject to the federal budget process. These agencies are funded from fees and assessments collected and earnings on investments.

term funding source for SEC.[35] According to SEC, even after the fee reduction, SEC fee collections are projected to bring in a sizable amount of revenues, of which those in excess of SEC's appropriation would be available to fund other programs. For example, in 2003, SEC appropriators will have approximately $1.3 billion in projected SEC fee collections from which to fund the agency versus the president's request of about $467 million.[36] In 2001, SEC collected almost $2.1 billion compared to its appropriated funding of $423 million. SEC fee collections and appropriated funding levels are shown in figure 7.

Figure 7: SEC Fees Collected and Appropriated Funding, 1991-2001 (billions of dollars)



Source: SEC.

[35] The law also mandated a GAO study of SEC self-funding, which is currently under way.

[36] The amendments include complex formulas designed to adjust SEC fee rates to result in predetermined amounts of fee collections over the next 9 years. Projected fee collections in excess of SEC's appropriation are available to fund other programs. Prior to the amendments' enactment, SEC was required to deposit a significant portion of its collections in the Treasury for general use. The amendments eliminated such deposits.

To respond to expanding markets and new challenges, SEC has requested additional resources and funding. For example, in 2001, SEC received funding for an additional 50 positions. However, in its 2002 budget, it lost 57 positions in order to absorb mandatory inflation-related increases that were not covered by its budget.[37] However, SEC received $3.9 million for special pay rates for its most experienced attorneys, accountants, and examiners in 2002. In its May 2001 authorization request submitted to Congress, SEC requested an additional $70 million in 2002, with adjustments for inflation for years thereafter, to fund staff pay parity. In addition for 2003, SEC requested authorization for an additional $36.4 million and 261 positions. According to SEC, these additional staff resources would allow it to (1) respond to new regulatory, oversight, and examination requirements of GLBA; (2) undertake joint regulation of the market for single stock futures and narrow-based index futures under the Commodity Futures Modernization Act of 2000; (3) enforce and support its new auditor independence rules; (4) monitor and review exchange automation efforts; and (5) continue combating Internet fraud and insider trading. As previously noted, SEC also requested an additional $13 million to support its information technology initiatives. The president's budget for 2003 did provide SEC an additional $7.6 million for certain technology and security initiatives but did not provide funding for any additional staff or for pay parity. As a result, SEC will continue to be restrained from fully addressing the new regulatory challenges and growing workload that it faces.

Strategic Planning Could Help SEC to Better Identify and Manage Its Resource Needs

Previous GAO reports noted that high-performing organizations identify their current and future human capital needs—including the appropriate number of employees, the key competencies needed for mission accomplishment, and the appropriate deployment of staff across the organization—and then create strategies for identifying and filling any gaps.[38] SEC generally has identified its available resources and determined what could be accomplished with existing staff. However, its inability to meet its goals due to resource constraints has resulted in SEC reconsidering the goals, for example, in its approach to selecting

[37] SEC was unaffected by this reduction in 2002 because it was absorbed from the agency's many vacant positions, about 250 at the time.

[38] See U.S. General Accounting Office, *Managing for Results: Next Steps to Improve the Federal Government's Management and Performance*, GAO-02-439T, (Washington, D.C.: Feb. 15, 2002) and *Determining Performance and Accountability Challenges and High Risks*, GAO-01-159SP, (Washington, D.C.: Nov. 2000).

corporate filings for review and the type of review selected. According to SEC officials, SEC's ability to redeploy its staff is limited by existing statutory requirements, which define the responsibilities that SEC must carry out and determine its use of the staff. Nevertheless, in determining how to address evolving issues, ideally, SEC would periodically evaluate the related resources needed to fulfill the full scope of its mission and develop strategies to achieve its goals.

We performed a limited review of SEC's strategic plan in light of its ongoing resource limitations and increased workload. We found that SEC has not engaged in a comprehensive strategic planning process. SEC's GPRA strategic plan includes four goals: "protect investors; maintain fair, honest, and efficient markets; facilitate capital formation; and sustain and improve organizational excellence." However, the performance measures for achieving these goals focus on outputs not outcomes. For example, SEC's objectives for protecting investors include deterring fraud and requiring compliance with the federal securities laws, promoting informed investment decisions, and promoting the prevention of fraud through investor education. However, the output-oriented performance measures include the number of enforcement actions taken, filings reviewed, examinations completed, and deficiencies identified. These measures generally would not help SEC gauge whether the actions taken actually result in greater protection for investors or establish the levels of these actions and activities needed to achieve its goals. In its annual GPRA performance plan and report, SEC has recognized that its performance measures are not outcome-oriented.

In addition to its 5-year strategic plan, SEC develops annual programmatic budget estimates and GPRA performance plans and reports addressing its strategic goals and performance results. However, neither of these documents provide the detailed analysis and information needed to make informed workforce decisions, including information on (1) the relationship between budget requests for full-time equivalent staff years and the ability to meet individual strategic goals and (2) any excesses or gaps in needed competencies within the agency's various divisions and offices. Such an analysis would call upon each division and office to accurately identify the human capital resources needed to achieve their respective strategic goals. This information could help SEC better determine the right size, skill needs, and deployment of its workforce to fulfill its goals and mission.

Conclusions

Securities markets have undergone tremendous growth and change over the past decade. More individuals than ever are invested in securities markets, either directly or through mutual funds. Likewise, these markets have become more complex and global as technology has fundamentally changed the way markets operate and how investors around the world interact with the markets. Moreover, the recent, sudden collapse of Enron Corporation and other corporate failures have stimulated an intense debate on the need for broad-based reform in such areas as financial reporting and accounting standards, oversight of the accounting profession, and corporate governance. All of these areas of possible reform hold significant repercussions and pose challenges for SEC's oversight role. At the same time, SEC has been faced with an ever increasing workload and ongoing human capital challenges, most notably high staff turnover and numerous vacancies.

SEC routinely prioritizes and allocates resources to meet agency demands, but SEC faces increasing pressure in managing its mounting workload and staffing imbalances that resulted from its workload growing much faster than its staff. Critical regulatory activities such as reviewing rule filings and exemptive applications and issuing guidance have suffered from delays due to limited staffing. According to industry officials, these delays have resulted in foregone revenue and have hampered market innovation. Oversight and supervisory functions have also been affected. For example, staffing limitations and increased workload have resulted in SEC reviewing a smaller percentage of corporate filings, an important investor protection function. In 2001, SEC reviewed about 16 percent of the annual corporate filings or about half of its annual goal of 30 to 35 percent. Although SEC is revamping its review process, recent disclosure and accounting scandals illustrate how important it is that SEC rise to the challenge of providing effective market oversight to help maintain investor confidence in securities markets. Although industry officials said that the challenges faced by SEC were in part attributable to resource constraints, they cited other issues such as SEC's high turnover rate, which in 2001 was almost twice the governmentwide rate. They said that SEC's high turnover created a staffing drain that often resulted in slower, less efficient regulatory processes. We explored the reasons for SEC's turnover rate and actions taken to address this problem in our 2001 human capital report.

Although SEC has taken numerous actions to address its high turnover including use of special pay rates and retention bonuses, the lack of funding for pay parity will provide little needed relief in the short-term. In the 2001 report, we also identified several issues beyond pay that warranted ongoing attention by management and recommended actions

on these issues that could help SEC mitigate its turnover problem. These actions included conducting periodic employee surveys to identify staff concerns, expanding SEC's human capital plan to include a strategy for succession planning, finding ways to involve human capital leaders in decision making, and working with the union to address the areas of dissatisfaction identified in our 2001 survey (i.e., lack of opportunities for advancement, the amount of uncompensated overtime, and quality of administrative support services).

Although SEC's workload and staffing imbalances have challenged SEC's ability to protect investors and maintain the integrity of securities markets, SEC has generally managed the gap between workload and staff by determining what basic, statutorily-mandated duties it could accomplish with existing resource levels. This approach, while practical, has forced SEC's activities to be largely reactive rather than proactive. For instance, SEC has not put mechanisms in place to identify what it must do to address emerging and evolving issues. Although SEC has a strategic plan and has periodically adjusted staffing or program priorities to fulfill basic obligations, SEC has not engaged in a much needed, systematic reevaluation of its programs and activities in light of current and emerging challenges. Given the regulatory pressures facing SEC and its ongoing human capital challenges, it is clear that SEC could benefit from some additional funding. However, a comprehensive, agencywide planning effort could help SEC better determine the optimum human capital and funding needed to fulfill its mission.

Recommendations for Executive Action

We recommend that the chairman, SEC, develop short-term and long-term strategies to address the challenges SEC faces. In the short-term, we recommend that SEC take definitive steps to continue to address its turnover problem and fill its vacant positions. These actions should include exploring use of its no-year fund to expand recruiting and retention efforts to ensure that all available resources are maximized to attract and retain staff. Likewise, we recommend that SEC explore innovative ways to attract senior level staff and bring in additional information technology expertise to better position itself to oversee evolving securities markets.

In the long-term, we recommend that the chairman, SEC, address several issues relating to strategic planning by broadening SEC's strategic planning process to systematically determine regulatory priorities and resource levels needed to fulfill its mission. Furthermore, we recommend that once SEC has completed the strategic planning process, each division

and office accurately identify the skills needed to perform the regulatory priorities identified. Once this is completed, we recommend that SEC link the strategic plan to staffing allocation and workforce determinations and expand its existing recruiting effort to include any additional disciplines identified as necessary to effectively regulate evolving securities markets.

Agency Comments and Our Evaluation

SEC provided written comments on a draft of this report that are reprinted in appendix I. In general, SEC agreed with most of the report's findings, conclusions, and recommendations. In particular, SEC strongly supported our recommendation that strategic planning could help SEC better identify and manage its resource needs. SEC said that it had earlier planned to perform an in-depth review of its operations, effectiveness, and resource needs. However, the events of September 11th, the loss of SEC's Northeast Regional Office, and the recent bankruptcy of Enron Corporation have prohibited that review. Nevertheless, SEC stated that it was committed to completing an in-depth review of SEC's resource needs.

In response to our recommendation that SEC take definitive steps to address its staffing problem, SEC agreed that the lack of funding for pay parity would provide it with little needed relief in the short term. However, SEC stated that, despite the lack of funding, it was planning to implement and manage pay parity within the agency. SEC will soon submit a Pay Parity Implementation Report to Congress and the Office of Personnel Management. The report is to consider the challenges SEC faces in implementing pay parity in light of all of the various interests in the issue. Although we have not reviewed SEC's specific implementation plan, developing a plan to implement pay parity is a vital step in improving SEC's staff recruiting and retention efforts.

Scope and Methodology

To determine how the markets and SEC's workload have changed, we analyzed various securities markets and SEC workload trend data. The various workload data used include numbers of corporation and investment company filings, complaints and inquiries, rule proposals, various industry interpretive and exemptive requests, investigations opened, and investment company and investment adviser assets under management, and examinations and inspections conducted. These workload data are published as part of SEC's annual budget request. We did not attempt to verify any of these data.

To determine whether SEC's resources and workload have affected SEC's ability to regulate and oversee the markets, we interviewed current and

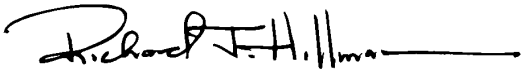
past SEC officials, including division and office directors, regional office directors, budget officials, former commissioners, and academics. Likewise, to obtain views from industry officials regarding how well SEC is functioning; we met with officials from various exchanges, associations, investment companies, and broker-dealers. Although SEC and industry officials agreed that the length of time taken to complete various reviews and issue guidance had increased, we were unable to quantify these effects, because SEC was unable to provide consistent detailed statistics on the time it takes to complete certain regulatory processes for the program areas discussed in the report such as reviewing filings, issuing guidance, and reviewing applications. We also obtained these parties' views about any other factors that may affect SEC's ability to fulfill its mission.

We also met with OMB officials regarding SEC's budget and the federal budget process. We met with banking industry regulators to obtain information on their funding and budget processes. We reviewed SEC GPRA performance plans and reports and recent GAO reports that address strategic planning at high performing organizations. We also reviewed relevant GAO reports on SEC's oversight and its operations.

We did our work in Los Angeles and San Francisco, California; Washington, D.C.; and New York, New York, between April 2001 and February 2002 in accordance with generally accepted government auditing standards.

We are sending copies of this report to the ranking minority members of the Senate Committee on Banking, Housing, and Urban Affairs and its Subcommittee on Securities and Investment; the chairman and ranking minority member, Senate Committee on Governmental Affairs; the chairman and ranking minority member, House Committee on Financial Services; and other interested congressional committees. We will also send copies to the chairman of SEC and will make copies available to others upon request.

If you or your staff have any questions regarding this report, please contact me or Orice M. Williams at (202) 512-8678. Key contributors to this report were Toayoa Aldridge, Edwin Lane, Barbara Roesmann, and David Tarosky.



Richard J. Hillman, Director
Financial Markets and Community Investment

Appendix I: Comments from the Securities and Exchange Commission

THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

February 28, 2002

Mr. Richard J. Hillman
Director
Financial Markets and Community Investment
U.S. General Accounting Office
441 G Street, N.W.
Washington, DC 20548

Re: Draft Report Entitled SEC Operations: Increased Workload Creates Challenges

Dear Mr. Hillman:

Thank you for the opportunity to review and comment on the General Accounting Office's draft report addressing whether the Securities and Exchange Commission has sufficient resources to stay abreast of changes in the securities markets. The report identifies how securities markets have changed in recent years, and assesses whether the SEC's resource levels and workload have affected the Commission's ability to regulate and oversee the markets.

We agree with most of the conclusions that GAO draws in the draft report. In particular, we agree that securities markets have experienced unprecedented growth and change in the last decade, that the markets have become more complex and international, and that legislative changes have spurred new products and created new regulatory responsibilities. We also agree that the SEC's ability to fulfill its mission has become increasingly strained. As noted in the report, SEC resource levels have not grown commensurate with its workload, and the SEC faces continuing challenges from its high staff turnover rate and difficulty in hiring qualified staff.

We also strongly support the report's recommendation that strategic planning could help the SEC to better identify and manage its resource needs. 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 prior to the beginning of the fiscal 2003 budget process. With the events of September 11th, the loss of our Northeast Regional Office, and the recent bankruptcy of Enron, I have not had the time to conduct a thorough review. Nevertheless, I am committed to completing an in-depth review of the SEC's resource needs in the coming months.

With respect to our staffing challenges in particular, we agree that the lack of funding for pay parity will provide us with little needed relief in the short term. It is critical that we receive current and future funding to implement an effective new compensation system. However,

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despite the lack of funding, we have developed a plan to implement and manage pay parity within the agency.

In accordance with the directive in the Investor and Capital Markets Fee Relief Act (P.L. 107-123), we soon will submit a Pay Parity Implementation Report to Congress and the Office of Personnel Management. The Report considers the challenges we face in implementing pay parity in light of all of the various interests in the issue. In developing our compensation system, we strove to strike a delicate balance among competing interests that include the goals of the Administration, the concerns of Congress, and equity issues within the Agency. Recognizing our responsibility to appropriately manage performance as we improve staff compensation, our system includes implementing a strong system with merit/pay-for-performance principles, not large, across-the-board pay increases that we believe are inappropriate for the federal service.

We tried to take best practices from all areas when developing this system and to learn from the experiences of the other financial regulatory agencies. Our intent with this reasonable approach is to provide increases to all staff in a way that can be implemented quickly, while also recognizing that this will be an on-going, long-term effort. In seeking comparability with the other federal financial regulatory agencies, the SEC and our compensation consultant conducted various analyses of the salary and benefit structures that they provide. The research shows that there is a range of approaches available and that differences do exist among how each agency has decided to compensate their staff and how successful they have been.

To ensure that the SEC acts responsibly, we are taking a rather conservative approach that will place the agency's proposed salary structure toward the lower end of those that we analyzed. We believe this will allow us the opportunity to ascertain over time how well our system is working before we get locked into a structure that might not meet our goals. In addition, the mix between salaries and benefits is not yet known at this time, as these items are negotiable with the union that represents a majority of SEC employees. To begin the program we plan to maintain the same benefits as are currently available to all Federal employees.

Our proposed pay scale has 20 levels, each with up to 31 steps. Most staff will be placed within levels 1 through 17 (that include two additional supervisory levels), as opposed to the current 15 general schedule grades. Levels 18 through 20 are the executive levels with broad pay ranges, instead of the current 6. The step structure is designed to make extra steps available to attorneys, accountants, and securities compliance examiners with securities industry experience. Our goal is to apply this new structure so that we can have a broader range of salaries available to aid in hiring new employees and to provide incentives to staff to improve their performance.

With respect to our immediate resource needs, we are conducting an evaluation as part of the fiscal 2003 budget process. As you know, the authorization process gives the SEC the opportunity to independently determine its needs and make a corresponding budget request. We are actively engaged in this process.

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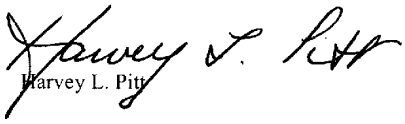
While I cannot predict with absolute certainty what the results of our in-depth evaluation of resource needs will be, we will conduct the review recognizing the challenges we face, asking ourselves tough questions, and remaining mindful of the competing and important priorities our government faces.

Thank you and your staff for the courtesy extended during this review.

Yours truly,



Harvey L. Pitt

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