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Report to Congressional Requesters

July 2002

SEC OPERATIONS

Implications of Alternative Funding Structures

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Contents

Letter 1

Results in Brief 2
Background 5
A Range of Self-Funded Structures Exist, but Not All Meet the Act's Definition of Self-Funding 9
A Move to Self-Controlled Funding Would Have Implications for SEC Operations 12
Depending on the Structure, Self-Funding Could Impact Congressional and OMB Oversight 17
Conclusions 21
Agency Comments and Our Evaluation 22

Appendix I **Scope and Methodology** 26

Appendix II **Comments from the Securities and Exchange Commission** 27

Appendix III **GAO Contacts and Staff Acknowledgments** 30

GAO Contacts 30
Acknowledgments 30

Table

Table 1: SEC Budget Estimates and Appropriations (dollars in thousands) 20

Figures

Figure 1: SEC Fees Collected and Appropriated Funding, 1991–2001 7
Figure 2. Federal Financial Regulatory Agencies Have Varied Missions 11
Figure 3: SEC's Budget Process 15

Abbreviations

CJS	Subcommittee on Commerce, Justice, State, and the Judiciary, Committee on Appropriations, U.S. Senate; and Subcommittee on Commerce, Justice, State, the Judiciary, and Related Agencies, Committee on Appropriations, House of Representatives
FCA	Farm Credit Administration
FDIC	Federal Deposit Insurance Corporation
FRS	Federal Reserve System
NCUA	National Credit Union Administration
OCC	Office of the Comptroller of the Currency
OFHEO	Office of Federal Housing Enterprise Oversight
OMB	Office of Management and Budget
OTS	Office of Thrift Supervision
SEC	Securities and Exchange Commission

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United States General Accounting Office
Washington, DC 20548

July 16, 2002

Congressional Requesters:

This report responds to a mandate in the Investor and Capital Markets Fee Relief Act (the Act) for GAO to study the implications of converting the Securities and Exchange Commission (SEC) to a self-funded basis.[1] Although SEC is fully funded through fees it collects, SEC's current funding structure differs from the Act's definition of self-funding. The Act defines self-funding as an authorization for SEC "to deposit the receipts of its collections in the Treasury of the United States, or in a depository institution, but such deposits are not treated as Government funds or appropriated monies, and are available for the salaries and other expenses of the Commission and its employees without annual appropriation or apportionment."[2] Although SEC currently deposits its collected fees in the Treasury, where its deposits are treated as offsetting collections and not general funds of the Treasury,[3] it cannot deposit its fees in a depository institution, and its monies are annually appropriated and apportioned.[4] In this report, we refer to the Act's definition of self-funding as a self-controlled funding structure.

Although the Act provides a specific definition for self-funding, as agreed with your offices, we explored a range of self-funding structures. Our objectives were to (1) identify the self-funding structures created by Congress for other financial regulators and the extent of control afforded

[1]Pub. L. No. 107-123, § 10, 115 Stat. 2390 (2002).

[2]In addition, the Act states that self-funded means that "the agency is authorized to employ and fix the salaries and other compensation of its officers and employees, and such salaries and other compensation are paid without regard to the provisions of other laws applicable to officers and employees of the United States."

[3]The Office of Management and Budget (OMB) defines offsetting collections as "monies that are deducted from outlays, rather than counted on the receipts side of the budget. They are often paid in return for providing goods or services." Offsetting collections are typically credited to an appropriation or fund account and are generally made available for obligation without further legislative action. However, annual appropriations acts may include limitations on the obligation of the funds.

[4]Appropriations authorize federal agencies to incur obligations and make payments out of the Treasury. Apportionment is the process by which OMB makes amounts available to an agency for obligation by time periods (usually quarters), activities, projects, objects, or a combination thereof.

to the appropriators under each; (2) identify the potential implications for SEC's operations if SEC's current budget structure were changed; and (3) identify the potential implications for congressional and executive branch oversight of SEC if SEC's current budget structure were changed.

In addressing these objectives, we obtained information from SEC and financial service regulatory officials on their funding structures and the implications of these structures. We also interviewed representatives of other institutions that would be affected by moving SEC to a more self-controlled funding structure. Finally, we relied on existing GAO work and relevant reports. A complete description of our methodology can be found in appendix I.

Results in Brief

Congress has created a range of self-funding structures for financial regulatory agencies that rely on fee collections, assessments, or other sources of funding rather than on appropriations from the Treasury's general fund. The variations among these agencies can be attributed to how and when Congress makes the fees available to an agency and how much flexibility Congress gives an agency in using its collected fees without further legislative action. For some agencies, such as the Farm Credit Administration (FCA) and the Office of Federal Housing Enterprise Oversight (OFHEO), Congress limits the amount of assessments to be collected and made available through provisions in annual appropriations acts. Therefore, these agencies would not meet the Act's definition of self-funding. In contrast, Congress provided permanent budget authority to the federal banking agencies—Federal Reserve System (FRS), Office of the Comptroller of Currency (OCC), Office of Thrift Supervision (OTS), Federal Deposit Insurance Corporation (FDIC), and National Credit Union Administration (NCUA)—allowing these agencies to use all the funds collected without further legislative action. These agencies are generally not included in the annual appropriations process and more closely fit the Act's definition of self-funding.

Moving SEC to a more self-controlled funding structure has implications for SEC operations in two important areas. First, SEC would have more control over its own budget and funding level, which some SEC and industry officials believe may better enable SEC to take steps to address its increasing workload and some of its human capital challenges, such as its ability to recruit and retain quality staff. For example, with a more self-controlled funding structure, SEC could use available fee collections to increase its staff level to address a rising workload, or increase its budget

in order to expand programs to recruit and retain quality staff without congressional or administration approval. However, others who are also knowledgeable about SEC's operations questioned whether more budget flexibility is the best means to address SEC's staff recruitment and retention issues. For example, one official believed that there are more efficient ways to effect a change in SEC's budget than conversion to a self-controlled funding structure. A second implication for SEC's operations is the resultant loss of checks and balances currently provided by the federal budget and appropriations processes. SEC would have to establish a system of budgetary controls to ensure fiscal restraint. Such fiscal discipline is important for agencies funded outside the appropriations process because they can no longer rely on appropriations increases during revenue shortfalls. Creating a system of internal controls within the budget process could prove particularly challenging for SEC, which lacks a comprehensive strategic planning process. As we found in our previous work on SEC operations, SEC had weaknesses in its existing budget and planning processes.[5]

Moving SEC to a self-controlled funding structure would diminish congressional and executive branch oversight. Specifically, the Act's self-funding definition would remove SEC from both the congressional appropriations process and OMB's apportionment process. On the other hand, the congressional authorizing committees would maintain or else could choose to increase their oversight of SEC. However, if Congress wanted to give SEC greater budget flexibility but still maintain some degree of control over SEC's funding level, it could place a variety of limitations on SEC's offsetting collections. These limitations could include designating fees for SEC's use but limiting amounts to those appropriated annually; specifying the amount of fees to be collected; controlling the size of SEC or a particular SEC program by limiting the amounts available for obligation; and specifying the purpose for which fees can be used. In addition, OMB could continue to be involved by apportioning funds by amounts, timing, program, or other methods. Another implication of self-controlled funding is that SEC's offsetting collections would not be available to offset funding for other discretionary spending within the appropriations bill that funds SEC.

[5]U.S. General Accounting Office, *SEC Operations: Increased Workload Creates Challenges*, GAO-02-302 (Washington, D.C.: Mar. 5, 2002). This report will be referred to as the SEC operations report.

The purpose of this report is to identify various existing, self-funding structures and the implications for SEC operations and congressional oversight if SEC's current funding structure were changed. Therefore, we are making no recommendations in this report on whether or how to change SEC's current funding structure. In comments provided on a draft of this report, SEC agreed that the report correctly identifies the principal consequences of moving SEC to a self-funded structure. However, SEC commented on several issues we identified that SEC would have to address were it to be given self-funding authority.

- In response to our observation that SEC would need to adequately manage its annual fee collections if it were to be moved outside of the traditional budget process, SEC stated that its current experience in adjusting its fees provided it valuable experience in this area. We did not question SEC's ability to adequately manage its fee collections, but rather we observed that SEC as required by statute relies on transaction-based fees, which we continue to believe generate revenues that are less predictable and more difficult to estimate than the assessments used by bank regulators to fund their operations.

- SEC commented on our observation that SEC would have to improve its budget planning process and stated that as a general matter, it has been constrained by the current budget process and would welcome the opportunity under a self-funded structure to develop a more forward-looking, strategic planning process. As stated in the report, SEC's annual budget is based on the past year's appropriations rather than on what is actually needed to fulfill its mission. Although this approach may be practical in the current context, we continue to believe that it would be useful for SEC to determine its staffing and resource needs to fulfill its mission regardless of its funding status.

- SEC stated that our discussion of the fiscal discipline that would be required if SEC were given self-funding authority would benefit from an analysis of SEC's experience with unobligated balances derived primarily from fees collected in excess of amounts used to offset its appropriation.[6] However, we are not persuaded that additional analysis of SEC's use of these balances would be beneficial to the report, because SEC does not have total control over the use of these unobligated funds. That is, in most

[6]SEC's funds are appropriated on a "no-year basis," and funds that have not been obligated or expended by the end of the fiscal year are carried forward as SEC's unobligated balances.

cases the fiscal restraint provided by the current budgetary process is still a factor, because SEC is still subject to OMB and congressional review of its reprogramming proposals. In the absence of external fiscal discipline, we continue to believe that self-funded agencies have to establish systems to instill the fiscal restraint that would have been provided by the budget and appropriations processes.

We have reprinted SEC's written comments in appendix II, and we discuss these comments in greater detail near the end of this letter.

Background

Congress created SEC in 1934 to administer and enforce the federal securities laws to protect investors and maintain the integrity of the securities markets. SEC's mission is 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. SEC works to fulfill this mission through various divisions and offices, among them the Office of the Executive Director, which formulates SEC's budget and authorization strategies.

Congressional Oversight

As a federal agency, SEC is subject to congressional oversight. Congress oversees federal agencies primarily through two distinct but complementary processes—authorizations and appropriations, which are implemented through authorizing and appropriating committees in the U.S. Senate and House of Representatives. The authorizing committees are responsible for creating a program, mandating the terms and conditions under which it operates, and establishing the basis for congressional oversight and control. SEC's authorizing committees are the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services. The appropriations committees and subcommittees are charged with assessing the need for, amount of, and period of availability of appropriations for agencies and programs under their jurisdiction. SEC's annual appropriations are under the jurisdiction of the Subcommittee on Commerce, Justice, State, and the Judiciary, U.S. Senate Committee on Appropriations; and the Subcommittee on Commerce, Justice, State, the Judiciary, and Related Agencies, House Committee on Appropriations.[7]

[7]These two subcommittees are generally abbreviated as CJS.

SEC Fee Collections

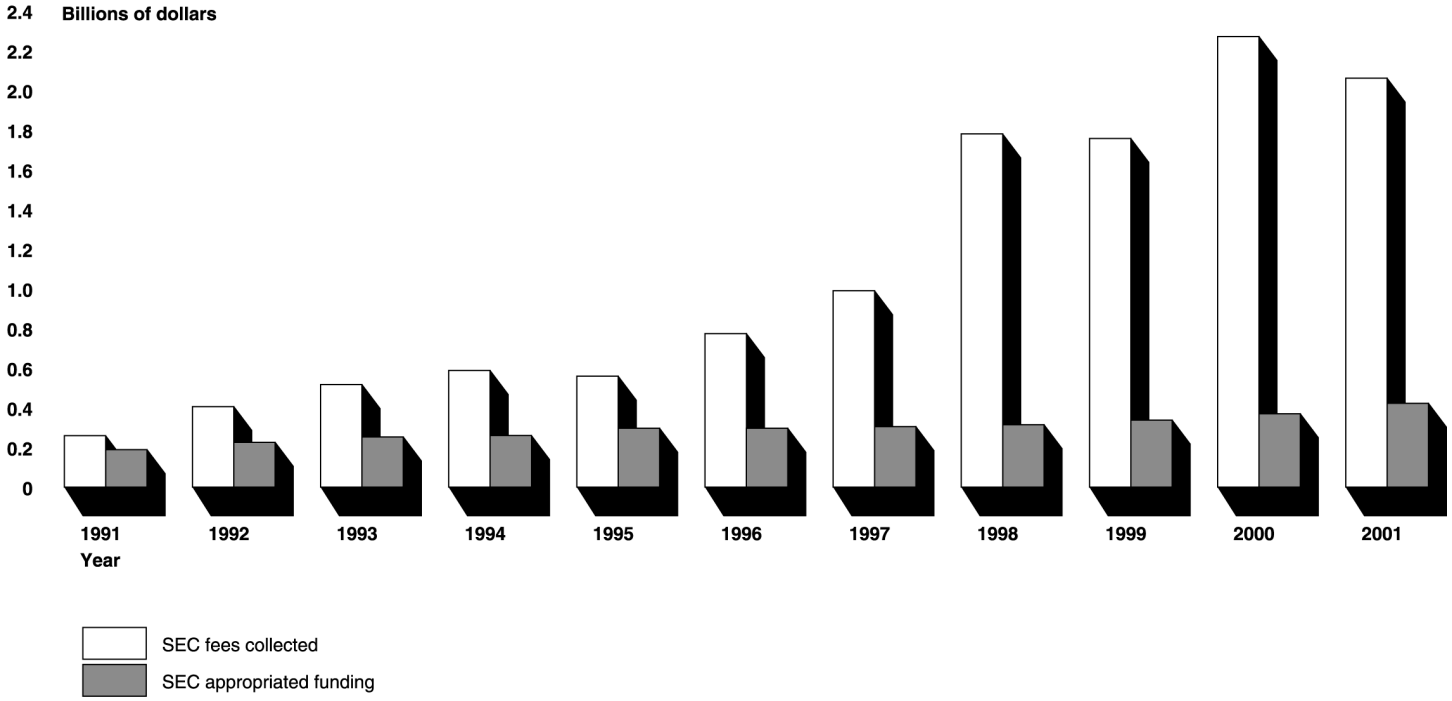
To fund its operations, the federal securities laws direct SEC to collect fees. SEC generally collects three types of fees:

- Securities registration fees, which are required to be collected under Section 6(b) of the Securities Act of 1933 (the Securities Act), are paid when companies register with SEC new stocks and bonds for sale to investors. In 2001, SEC collected $987 million in Section 6(b) fees;
- Securities transaction fees, which are required to be collected under Section 31 of the Securities Exchange Act of 1934 (the Exchange Act) are paid by national securities exchanges and national securities associations when registered securities and security futures are sold on or off exchanges through any member of such an association. In 2001, SEC collected $1.04 billion in Section 31 fees; and
- Fees on proxy solicitations for mergers, consolidations, acquisitions, or sales of a company's assets, which are required to be collected under Section 14(g) of the Exchange Act, are paid by the person filing proxy solicitation materials for such transactions. Fees on the purchase of securities by an issuer of its issued securities are paid by the issuer under Section 13(e) of the Exchange Act. In 2001, SEC collected $33 million in filing fees.

SEC fees are deposited in a special SEC appropriations account to be used as offsetting collections. Although the fees were enacted to fund SEC operations, figure 1 illustrates how the amount of fees collected in recent years has far exceeded SEC's appropriated budget. For example, in 2000, SEC collected $2.27 billion in fees, while the agency's 2000 budget was $368 million. Similarly, in 2001, SEC collected about $2.1 billion, while its 2001 budget was $423 million.[8] Projected fee collections in excess of SEC's appropriations are available to SEC's appropriators to fund other priorities within the CJS appropriations bill.

[8]All years are fiscal years unless otherwise noted.

Figure 1: SEC Fees Collected and Appropriated Funding, 1991–2001



Source: SEC.

SEC Fee Reductions

Congress first addressed the issue of excess SEC fees in 1996 through the National Securities Markets Improvement Act of 1996, which reduced registration and transaction fees.[9] However, SEC's fee collection grew even higher because of subsequent increases in stock prices and stock trading volume. Viewing these excess fees as an unwarranted tax on investment and capital formation, Congress enacted the Investor and Capital Markets Fee Relief Act on January 16, 2002. The Act substantially reduces the fees collected by SEC and designates all such fees as offsetting collections available to fund the operations of the agency, to the extent provided by Congress. Prior to the enactment of this Act, most of the fees collected were deposited in the U.S. Treasury general fund as revenue. The Act also reduces the basic rates for transaction fees, registration fees, stock repurchase fees, and merger and acquisition fees, and it eliminates certain other filing fees. The Act includes "target

[9]Pub. L. 104-290 §§ 404 & 405, 110 Stat. 34166 (1996) (codified at 15 USC §77 f & 78ee prior to further amendments).

offsetting collection amounts" for both transaction and registration fees for fiscal years 2002 through 2011. SEC would be required to adjust the basic rates for those fees to make it "reasonably likely" that collections would equal the target amounts.

Current Funding Issues

The Act also grants SEC the authority to pay its employees' salaries and benefits at levels commensurate with those paid by the federal banking regulators (pay parity). For 2003, SEC currently estimates the additional cost of implementing pay parity to be $76 million. SEC anticipates that the funding to accommodate this increase will be provided exclusively out of the amount of fees SEC is scheduled to collect annually under the Act and appropriated by Congress. Although SEC fee collections as estimated for 2003 in the Act total $1.33 billion, the President's 2003 Budget request included a budget estimate of $466.9 million for SEC. This amount represents a $29 million, or 6.6 percent, increase over SEC's 2002 budget of $437.9 million but does not include any funding for a pay parity program in 2003. To date, Congress has not enacted SEC's 2003 appropriation.

SEC's Workload and Staffing Issues

As reported in our SEC operations report,[10] SEC is operating in an increasingly dynamic regulatory environment. Over the past decade, the securities markets have undergone tremendous growth and innovation as technological advances have increased the complexity of the markets and the range of products afforded to the public. Larger, more active, and more complex markets have produced more market participants, registrants, filings, examinations and inspections, legal interpretations, complaints, and opportunities for fraudulent activities. In our SEC operations report, SEC and industry officials agreed that SEC's ability to fulfill its mission in such a dynamic environment has become increasingly strained as SEC's growing workload has substantially outpaced increases in its staffing levels. Specifically, over the past decade, we found that staffing within SEC's various oversight areas has grown between 9 and 166 percent, while workload measures in those areas have grown from 60 to 264 percent. Moreover, following the sudden and highly publicized collapse of Enron Corporation and other corporate failures, SEC has been under increasing pressure to ensure that it is equipped to adequately oversee the securities markets and to ensure that investors receive accurate and meaningful financial disclosure, an important part of SEC's mission to protect

[10] GAO-02-302.

investors. In addition, legislative changes such as the Gramm-Leach-Bliley Act of 1999, the Commodity Futures Modernization Act of 2000, and the USA Patriot Act of 2001 placed added demands on SEC's limited resources. All of these changes have significant repercussions and pose challenges for SEC's oversight role. In light of these challenges and prompted by concerns about SEC's ability to carry out its mission, legislators introduced H.R. 3764 and S. 2673, both of which would authorize appropriations for SEC of $776 million, and H.R. 3818, which would authorize appropriations for SEC of $876 million.[11] Both House bills would designate more than half of these amounts for the Division of Corporate Finance and the Division of Enforcement to increase enforcement in financial reporting cases and other oversight initiatives. The Senate bill designated specific amounts for pay parity, information technology, and additional staff for oversight of audit services.

A Range of Self-Funded Structures Exist, but Not All Meet the Act's Definition of Self-Funding

Federal financial regulators are largely self-supporting through fee collections, assessments, or other funding sources, but not all of these self-funding options meet the Act's definition of self-funding. The variation among federal agencies is attributable to how and when Congress makes the funds available to the agency and how much flexibility Congress gives the agency in using the fees or other funding sources it collects. At some agencies, Congress limits the amount of assessments collected or available for agency use. Such limitations are generally established by provisions in annual appropriations acts. For example, funding for SEC in 2002 was appropriated from fees collected in 2002 and prior years. In SEC's case, although all the offsetting collections by definition are dedicated to SEC, Congress limits how much fee revenue is available. For example, in 2001, SEC collected about $2.1 billion in fees; however, Congress appropriated about $423 million for SEC's operations. Therefore, almost $1.7 billion was available to the CJS subcommittees to offset spending for other agencies and programs under CJS jurisdiction.

There are other regulatory agencies, such as FCA and OFHEO, which also operate at this more congressionally controlled end of the self-funding

[11]To date, all these bills are still pending. Representative Michael G. Oxley introduced H.R. 3764, which was approved by the House of Representatives on June 26, 2002. Representative John H. LaFalce introduced H.R. 3818, which has been referred to the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, House Committee on Financial Services. Senator Paul Sarbanes introduced S. 2673 to the Senate Committee on Banking, Housing, and Urban Affairs.

range (see fig. 2 for a description of these two agencies' missions as well as the missions of other financial services regulators). Although FCA and OFHEO fund their operations solely by assessments from their regulated entities, these agencies remain subject to the appropriations process. That is, Congress establishes annual limits through the appropriations process by approving the amount of assessments these agencies can collect. For example, in 2001, Congress appropriated $40 million to FCA, which authorized FCA to collect assessments up to this amount as offsetting collections for 2001. Moreover, Congress limits the amount of assessments that FCA can obligate for administrative expenses. For example, in 2001, FCA's obligation for administrative expenses was limited to about $38 million. Congress also establishes OFHEO's budget in a similar manner.

Figure 2. Federal Financial Regulatory Agencies Have Varied Missions

Farm Credit Administration (FCA) is the federal regulator for the Farm Credit System. It is responsible for supervising, regulating, and examining the operations of institutions subject to the Farm Credit Act of 1971. FCA's mission is to promote a safe, sound, and competitive Farm Credit System.

Office of Federal Housing Enterprise Oversight (OFHEO) examines and regulates Freddie Mac and Fannie Mae, which are government-sponsored, privately owned and operated corporations established by Congress to enhance the availability of mortgage credit across the nation. OFHEO's primary mission is ensuring the capital adequacy and financial safety and soundness of Fannie Mae and Freddie Mac.

Federal Reserve System (FRS) is our nation's independent, decentralized central bank. It is responsible for conducting monetary policy, maintaining the stability of financial markets, providing services to financial institutions and government agencies, and supervising and regulating banks and bank holding companies. Its primary mission is to support a stable economy.

Office of Comptroller of the Currency (OCC) charters, regulates, and supervises national banks. It also supervises federal branches and agencies of foreign banks in the U.S. OCC charters, regulates, and supervises national banks to ensure a safe, sound, and competitive national banking system.

Office of Thrift Supervision (OTS) is the federal regulator for all federally insured, federally chartered and many state-chartered thrifts and thrift holding companies. Its mission is to effectively and efficiently supervise thrift institutions to maintain their safety and soundness in a manner that encourages a competitive industry.

Federal Deposit Insurance Corporation (FDIC) regulates federally insured state-chartered, non–Federal Reserve member banks and federally insured state savings banks. Its mission is to contribute to the stability of and public confidence in the nation's financial system by insuring deposits, examining and supervising financial institutions, and managing receiverships.

National Credit Union Administration (NCUA) charters, regulates, and insures federally chartered credit unions in the United States and insures the majority of the state-chartered credit unions. It regulates federally insured credit unions, which include corporate credit unions. NCUA's mission is to foster the safety and soundness of federally insured credit unions and to better enable the credit union community to extend credit for productive and provident purposes.

Source: Financial regulatory agencies listed above.

On the other hand, Congress has granted more self-controlled funding structures to other agencies. Some of these agencies have permanent indefinite appropriations, which means that these agencies can use whatever amount of funds are collected without any further legislative action. Agencies at this less congressionally controlled end of the range include the federal banking agencies (that is, FRS, OCC, OTS, FDIC, and NCUA). Unlike SEC, which is generally funded by transaction fees and registration-based fees and subject to annual appropriations, these

agencies are supported almost entirely through examination or assessment fees on their members, deposit insurance premiums, or interest on asset holdings, and are not included in the annual congressional appropriations process. The bank regulators' self-funding structure most closely fits the Act's definition of self-funding. According to banking agency officials, they, not Congress, control their agencies' budget growth and direct how their agencies spend their funds. Although SEC continues to be subject to annual appropriations, the Act moved SEC closer to having the same authority as the banking agencies by allowing SEC to establish the compensation and benefit levels of its employees.

A Move to Self-Controlled Funding Would Have Implications for SEC Operations

Moving SEC to a more self-controlled funding structure has two important implications for SEC's operations. First, SEC would have more control over its own budget and funding level, which some SEC and industry officials believe may better enable SEC to take steps to address its increasing workload and some of its human capital challenges, such as recruiting and retaining quality staff. However, others knowledgeable about SEC's operations questioned whether more budget flexibility is the best means to address SEC's recruiting and retention issues. Second, SEC would have an added responsibility in managing a more self-controlled funding structure. Self-funded agencies require sound fiscal control mechanisms to compensate for the removal of the scrutiny provided by both OMB and the appropriators, as part of the federal budget process. In addition, self-funded agencies require sound fiscal discipline to ensure revenue streams. In previous reports, we found weaknesses in SEC's existing budget and planning processes.

Self-Controlled Funding Would Afford SEC More Budgetary Flexibility to Address Workload and Human Capital Challenges

Some SEC officials told us that a more self-controlled funding approach might better enable SEC to address its increasing workload and ongoing human capital challenges, most notably high staff turnover and numerous vacancies. As mentioned previously, we reported in our SEC operations report that both SEC and industry officials agreed that current levels of human capital and budgetary resources have limited SEC's ability to address many current and evolving market issues at a time when the collapse of Enron and other corporate failures have increased SEC's workload and generated debates on reforms, which may result in increased responsibilities for SEC.[12] However, others knowledgeable about

[12] GAO-02-302.

the industry countered that while SEC may need more resources, there are more efficient ways to affect a change in SEC's budget than conversion to a self-controlled funding basis. For example, within the existing structure, SEC could justify budget increases to its authorization and appropriation committees beyond the amount included in the President's Budget.

Based on their experiences with self-funding, officials from the bank regulatory agencies we interviewed said that self-funding provided their agencies with more autonomy in formulating their budgets. They also said that having more control enabled them to respond more quickly to program needs in changing market conditions because they could reallocate or increase funding without having to wait for legislative action. SEC officials said they believed they would realize similar benefits in the human capital area because they would have greater control over their funding and would be able to respond quickly to changes in the market. For example, the 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. In response to these challenges and proposals for regulatory changes, SEC officials requested approval for 100 additional staff positions dedicated to reviewing corporate filings, enforcing securities laws, and providing accounting guidance. However, under the existing structure, Congress and the executive branch must approve any such increases in SEC's staffing allocation. Although there is general agreement on the need for these increased resources, SEC's request to increase staffing in these areas is included in a supplemental appropriations bill that was considered in April 2002 but is not yet enacted, as Congress is considering issues unrelated to SEC's funding needs. A more self-controlled funding structure would have allowed SEC to immediately implement its plan without the need for legislative action.

Another SEC official said that a more self-controlled funding structure would enable SEC to allocate resources to fund pay parity, allowing SEC to offer compensation packages similar to those offered by the bank regulators and putting SEC in a better position to attract and retain quality staff. SEC believes this could also help SEC stem turnover among its attorneys, accountants, and examiners—staff necessary to carry out SEC's mission. Although the rate had decreased from 15 percent in 2000 to 9 percent in 2001, turnover at SEC was still higher than the turnover rate

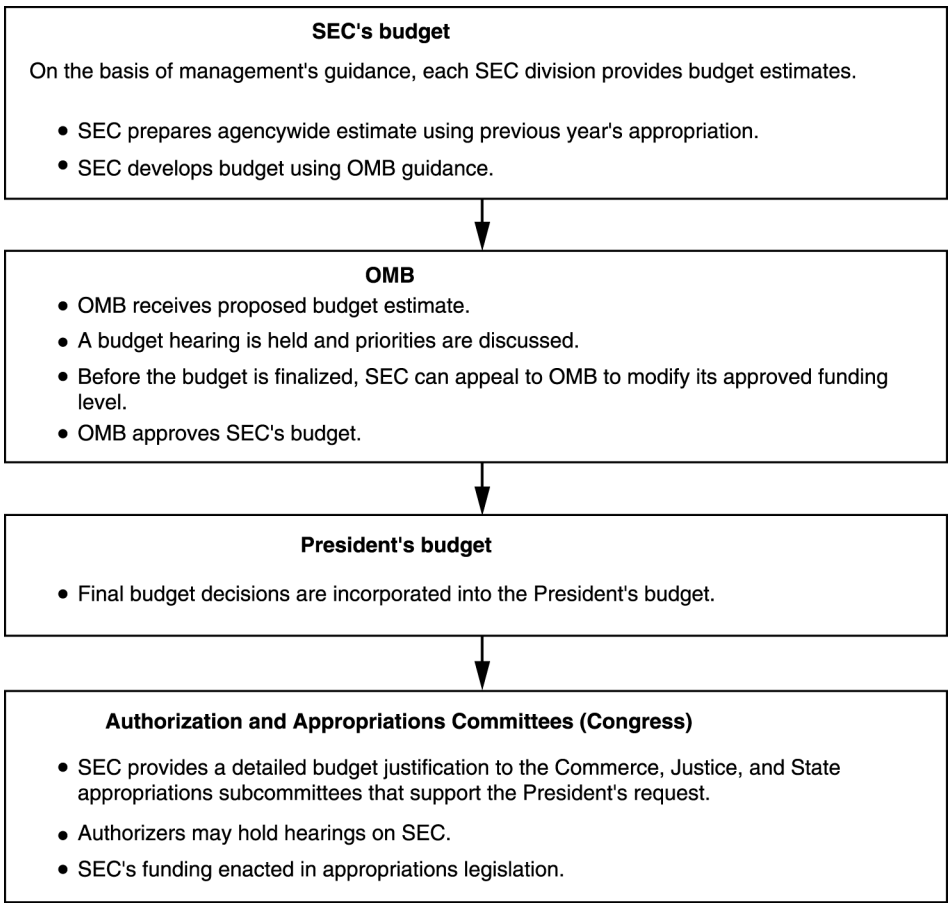
governmentwide in 2001. As we reported previously, most SEC employees who responded to our survey said that compensation was their primary reason for leaving or thinking of leaving SEC.[13] Although SEC officials acknowledged that turnover will always be an issue, they said that pay parity should enable SEC to lengthen the average tenure of attorneys and examiners. We previously reported that in 1999 the average tenure for attorneys was 2.5 years and for examiners 1.9 years. According to SEC officials, new employees need at least 2 years on the job to gain the knowledge and experience necessary to significantly contribute to SEC's mission.

Self-Controlled Funding Would Require Fiscal Discipline

Another implication of moving SEC to a more self-controlled funding structure is that it would require SEC to establish a system of internal controls to ensure fiscal discipline. Under SEC's current funding structure, OMB and the appropriations process provide fiscal discipline for the agency. For example, SEC's current annual budget cycle as illustrated in figure 3 begins with the preparation of an agencywide estimate that is based on the previous budget year's appropriation. SEC then develops a conforming budget estimate based on OMB's budget guidance, including a specified budget amount that OMB provides to SEC. After receiving OMB's approval, SEC's budget request is included in the President's Budget that is submitted to Congress. Under this structure, SEC's annual budget has been based on the previous year's appropriations rather than on what may be actually needed to fulfill its mission. While practical, as reported in our SEC operations report, we found that this type of reactive approach could diminish SEC's effectiveness, resulting in less effective enforcement and oversight. If moved to a self-controlled funding structure, not only would SEC have to improve its budget planning process by reviewing its staffing and resource needs independent of the budget process but the fiscal restraint provided within the federal budget process would be lost. Therefore, SEC would need to create its own internal control mechanisms and accountability structure to ensure fiscal discipline and budgetary restraint.

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

Figure 3: SEC's Budget Process



Source: GAO analysis of SEC's appropriations budget process.

Bank regulatory officials said that to compensate for not being subject to appropriations oversight, self-funding requires discipline in both planning and budget processes. For example, one bank regulatory official said that his agency has a budget process that mirrors the federal budget planning process: the head of the agency reviews the budget estimates for each division and holds "hearings" in which each division must justify its budget estimate, similar to OMB's budget process. Officials from NCUA, OCC, and OTS also said that their agencies routinely share their budgets with OMB as a courtesy.

In addition to their own internal processes, bank regulators also said that they experience some amount of regulatory competition and scrutiny from industry groups and regulated entities. These pressures provide incentives

to the regulators to keep their operations efficient. Four regulators oversee the banking industry: three charter commercial banks, and one charters thrift institutions. Moreover, commercial banks have the option of changing their national charter to a state charter, and thrifts can opt to switch from their thrift charter to one of the commercial bank charters. Unlike the bank regulators, SEC is the sole federal regulator overseeing the U.S. securities markets, and its regulated entities generally have no other regulatory options if they want to operate in the securities markets. However, this structure does afford SEC a certain amount of independence from its regulated entities, an independence that may not be afforded to other agencies facing regulatory competition. Additionally, SEC's fee payers may be less likely to scrutinize SEC's budget because unlike the banking industry, where the burden of paying assessment fees is limited to the regulated entities, the securities industry distributes the responsibility for paying SEC's transaction fees among all market participants. Therefore, in the absence of strong external pressures, a rigorous internal budget process and a related set of controls would be critical for SEC if it were to operate on a self-controlled funding basis.

Fiscal discipline is also important for self-controlled funding agencies because these agencies have no guarantee that they will be included in the appropriations process if they experience budget shortfalls. Instead, short of raising fees or assessments, some of these agencies, such as OCC and OTS, rely on backup sources of funding, such as reserves established from excess funds from previous years. These two agencies have established reserves to protect them during periods of revenue shortages. However, both agencies also have established internal policies that govern the appropriate use of these reserves. OCC and OTS officials said that their agencies now are less willing to use reserves during periods of revenue shortages. For example, the heads of these agencies have chosen to downsize and cut their expenses to maintain their budgets rather than use their reserves. Unlike the banking regulators, who have more control over the amount collected through assessments, SEC relies on transaction fees, which are less predictable and more difficult to estimate.

Finally, moving SEC to a more self-controlled funding basis would also increase the need for strategic planning, which also should be linked to the budget process. Based on our review of SEC's strategic plan in our SEC operations report, we found that SEC had not engaged in a comprehensive strategic planning process. We found that SEC had 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 has identified the resources necessary to fulfill the

full scope of its mission. Moreover, SEC's annual plans lacked the detailed analysis and information needed to make informed workforce decisions. We found that additional information on (1) any excess or gaps in needed competencies within the agency's various divisions and offices and (2) the relationship between budget requests for full-time equivalent staff years and SEC's ability to meet individual strategic goals could make SEC's budget process more meaningful. Introducing a meaningful strategic planning process at SEC could also make budget planning more proactive, rather than reactive, as is currently the case. SEC has begun to take steps to address these issues. In March 2002, SEC hired a consulting firm to work with an internal taskforce to perform an in-depth review of SEC's operations, effectiveness, and resource needs. However, SEC officials stated that because the 2003 budget has already been finalized under the current budget process, they were concerned that even if substantive improvements were recommended by the internal taskforce, the earliest that SEC would be able to effectively react to these changes would be the 2004 budget cycle.

Depending on the Structure, Self-Funding Could Impact Congressional and OMB Oversight

A shift in budgetary control from Congress and OMB to make SEC self-funded as defined in the Act poses various implications for oversight of SEC. It could reduce the amount of direct control over SEC's budget and operations, because the appropriators and OMB would no longer be involved in oversight. By shifting more control to SEC and its authorizing committees, CJS subcommittees would also lose the benefit of having SEC's fees available to offset spending for other discretionary spending purposes. However, Congress and OMB could compensate for this reduction in direct control by placing other spending limits on SEC.

Self-Funding Lessens Direct Congressional and OMB Control

If Congress granted SEC permanent authority to collect fees without further congressional action and authorized it to use whatever fees are collected—permanent indefinite appropriations—and posed no limitations, this shift to self-funding as defined by the Act would affect congressional oversight to a greater degree than other alternatives we considered. Under permanent indefinite appropriations, the appropriations committees generally would not be involved in overseeing SEC's appropriations. However, the authorizing committees and other oversight committees, such as the Senate Committee on Governmental Affairs and House Committee on Government Reform, could continue to oversee SEC, since congressional oversight is not limited to budgetary authority and remains an important tool for

- evaluating program administration and performance;
- making sure programs conform to congressional intent;
- ferreting out waste, fraud, and abuse;
- seeing whether programs may have outlived their usefulness;
- compelling an explanation or justification of policy; and
- ensuring that programs and agencies are administered in a cost-effective and efficient manner.

Shifting SEC's budget structure to a more self-controlled model would also diminish the role of OMB, which establishes the framework by which agencies formulate their budget estimates and is responsible for ensuring that agency budget requests are consistent with specific budgetary guidelines and spending ceilings. Currently, SEC prepares its budget request based on guidance from OMB and submits this estimate to OMB for review and approval (see fig. 3). A budget hearing is subsequently held and, during this hearing, any policy changes or shifts in the SEC Chairman's priorities are discussed. OMB then determines whether the proposals are consistent with the President's policy goals. This part of the process is significant from an oversight perspective, because OMB can increase or decrease SEC's budget request based on those evaluations. For example, OMB increased SEC's budget request by $8.6 million in 1995. According to SEC officials, OMB increased SEC's budget proposals to allow it to hire additional examiners. Most recently, OMB reduced SEC's 2003 budget request by about $95.5 million, most of which could have been used to fund pay parity. According to OMB officials, they would prefer that SEC not implement pay parity immediately but instead come up with a mechanism to fund it over time.

As table 1 illustrates, SEC has limited influence over appropriations levels. From 1992 to 2001, OMB reduced SEC's budget in all but 3 years. Likewise, the House of Representatives has voted to decrease SEC's funding as presented in the President's Budget every year. Conversely, the Senate has voted to restore most of the President's Budget each year. Generally, the result has been appropriations lower than SEC's budget request. In addition to annual appropriations, SEC has received supplemental appropriations or additional funding from other sources. For example, since 1994 SEC has received a supplemental appropriation or used its unobligated balances from prior years to increase its total funding level

above its appropriation.[14] If Congress wanted to give SEC greater control over its budget but still maintain some degree of control over SEC's funding level, it could place a variety of limitations on SEC's offsetting collections. These limitations include

- designating fees collected for SEC's use, but establishing limits on their use through annual appropriations;
- specifying the amount of fees to be collected and available for use in appropriations. If SEC were to collect more than that amount, Congress could specify that such amounts be designated to SEC, but not be made available without (further) congressional action;
- controlling the size of SEC or a particular program within SEC by limiting its obligations for specific purposes or to specific amounts; and
- limiting the purposes for which fees can be used. For example, Congress limits the amount of FCA's assessments that can be obligated for administrative expenses.

[14]Most of the unobligated balances were used to modernize EDGAR—Electronic Data Gathering Analysis and Retrieval—a database system through which public companies electronically file registration statements, periodic reports, and other forms with SEC.

Table 1: SEC Budget Estimates and Appropriations (dollars in thousands)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Estimate submitted to OMB	$249,082	$260,852	$274,803	$297,376	$350,766	$317,294	$317,412	$339,098	$367,800	$430,600
Action by OMB	-23,290	-11,091	-19,447	8,624	-7,844	-9,105	-	2,000	-7,000	-7,800
President's request	225,792	249,761	255,356	306,000	342,922	308,189	317,412	341,098	360,800	422,800
Action by House of Representatives	-68,307	-92,276	-197,500	-9,126	-45,517	-11,168	-2,412	-17,098	-36,800	-30,176
Subtotal	**$157,485**	**$157,485**	**$57,856**	**$296,874**	**$297,405**	**$297,021**	**$315,000**	**$324,000**	**$324,000**	**$392,624**
Action by the Senate	68,307	92,276	197,500[a]	7,708	-	9,379	2,412	17,098	46,800	97,028
Subtotal	**$225,792**	**$249,761**	**$255,356**	**$304,582**	**$297,405**	**$306,400**	**$317,412**	**$341,098**	**$370,800**	**$489,652**
Action by conferees	-	3,474	4,961	-7,177	-	-1,000	2,412	-11,098	-3,000	-66,852
Annual appropriation	225,792	253,235	260,317	297,405	297,405	305,400	315,000	330,000	367,800	422,800
Supplemental appropriation	-	-	-	-	-	-	-	8,175	500	-
Sequestration[b]/ other	-	-	-	-568	-384	-	-	-458	-	-
Use of prior years' unobligated balances	-	-	8,833	3,600	3,900	5,700	5,100[c]	18,357[d]	14,100[e]	4,472[c]
Total funding level	**$225,792**	**$253,235[f]**	**$269,150**	**$300,437**	**$300,921**	**$311,100**	**$320,100**	**$356,074**	**$382,400**	**$427,272**

[a]Funding reduced to $57.86 million, based on an assumption that fee language would be later enacted in permanent legislation to provide an additional $197.5 million in offsetting collections, thereby funding SEC in full at $255.36 million.

[b]Sequestration is generally the cancellation of budgetary resources provided by discretionary appropriations or direct spending law.

[c]Represents spending authority for 3-year EDGAR modernization.

[d]Includes $14.5 million for 3-year EDGAR modernization and $3.86 million from prior year recoveries.

[e]Includes $5.4 million for 3-year EDGAR modernization and $8.7 million reprogramming.

[f]Pending possible enactment of legislation amending the Investment Advisors Act of 1940, SEC's appropriation included authorization to collect and spend an additional $16 million in new fees for the direct costs of registration, inspection, and related activities. Such legislation was not passed in 1993.

Source: SEC 1995, 2000, and 2001 Annual Reports. GAO did not independently verify the accuracy of these numbers.

The OMB also has various ways of enforcing accountability that can constrain a program's operations. For example, through the apportionment process OMB can control the rate of obligations by controlling the rate at which budget authority is made available during the fiscal year. Finally, a department or agency independently may place administrative limits on funding, such as restricting the amount that can be used for travel or not allowing funds to be shifted between items of expense. For example, an agency might prohibit a program manager from purchasing a computer using funds allocated, but no longer needed, for salaries and benefits.

Self-Funding Would Eliminate Use of SEC's Offsetting Collections for Other Purposes

Another implication of self-controlled funding is that offsetting collections would no longer be available to offset funding for other discretionary spending purposes. As discussed earlier in this report, fees in excess of SEC's budget are used by the appropriators to offset funding for other priorities in the CJS appropriations bill. Self-controlled funding would allow SEC to dedicate the fees that it collects to fund its operations without further legislative action. Therefore, SEC's fees would not be available to offset spending for other federal programs. However, regardless of whether the SEC funding structure changes, CJS will have less funding available for discretionary spending because SEC's fees will decrease as mandated in the Act.

Conclusions

The decision on whether to change SEC's self-funding status and to what degree is a policy decision that resides with Congress. In deciding whether to move SEC to a more self-controlled funding structure, Congress will have to weigh the increase in flexibility afforded SEC against the loss in oversight provided by the appropriators and OMB. The increased funding flexibility would likely allow SEC to more readily fund certain budget priorities, such as pay parity, and to more quickly respond to the ever-changing securities markets. On the other hand, Congress and OMB would lose the ability to directly affect the budget and direction of the agency. In return for this added flexibility and control, SEC would have to develop its own system of fiscal controls and an accountability structure to address the loss of rigor and discipline provided by the federal budget and appropriations process.

Agency Comments and Our Evaluation

The Chairman, SEC, provided written comments on a draft of this report that are reprinted in appendix II. SEC agreed that the report correctly identified the principal consequences of moving SEC to a self-funded structure. However, SEC raised several concerns with our observations about the issues that SEC would have to address were it to be given self-funding authority. Specifically, SEC commented on our observations in the report that SEC would need to (1) adequately manage its annual fee collections if it were to be moved outside of the traditional budget process and (2) improve its budget planning process if it were given self-funding authority. SEC also stated that our discussion of the fiscal discipline that would be required if SEC were given self-funding authority would benefit from an analysis of SEC's experience with unobligated balances derived primarily from fees collected in excess of amounts used to offset its appropriation.

On the first issue, regarding the need for SEC to adequately manage fee collections, SEC stated that the report could benefit from a more robust discussion of SEC's responsibilities under the recently enacted Investor and Capital Markets Fee Relief Act. Among other things, this Act gives SEC the responsibility for adjusting fee rates on an annual and semi-annual basis, if necessary, to meet statutory "target collection amounts." SEC stated that it had developed an adjustment mechanism to perform this function that has provided SEC with useful experience that would be beneficial if it were to move to a self-funding structure. In our report we discussed the importance of fiscal discipline for self-controlled funding agencies, because these agencies are not guaranteed to be included in the appropriations process if they experience budget shortfalls. The report also recognized that the Act, enacted in January 2002, changed how SEC's fees are collected and statutorily established target offsetting collection amounts. We did not question SEC's ability to adequately manage its fee collections, but rather we observed that SEC as is required by statute relies on transaction-based fees, which we continue to believe generate revenues that are less predictable and more difficult to estimate than the assessments used by bank regulators to fund their operations.

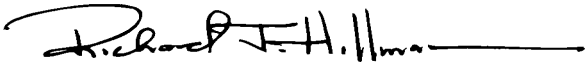
The second issue SEC raised was our observation that SEC's current budget planning process would have to be improved if it were converted to a self-funded basis, and it noted that "SEC's ability to be proactive with respect to budget planning is constrained by the requirements of OMB Circular A-11, and [SEC] will continue to be limited…in the absence of self-funding authority." As stated in the report, SEC's annual budget is based on the past year's appropriations rather than on what is actually needed to fulfill its mission. Although this approach may be practical in

the current context, we continue to believe that it would be useful for SEC to determine its staffing and resource needs to fulfill its mission regardless of its funding status. Nevertheless, we are encouraged by SEC's expressed commitment to improving its budget and strategic planning processes and the preliminary steps that are currently under way.

Finally, SEC expressed concern about the report's discussion of SEC's need for fiscal discipline, and stated that the report "would benefit from an analysis of the SEC's experience with unobligated balances," which according to SEC are "derived primarily from fees collected in excess of amounts used to offset [its] appropriation." As illustrated in table 1 of the report, SEC has used these balances in several years during the period covered. However, we are not persuaded that additional analysis of SEC's use of these balances would be beneficial to the report, because SEC does not have total control over the use of these unobligated funds. That is, in most cases the fiscal restraint provided by the current budgetary process is still a factor, because SEC is still subject to OMB and congressional review of its reprogramming proposals. In the absence of external fiscal discipline, we continue to believe that self-funded agencies have to establish systems to instill the fiscal restraint that would have been provided by the budget and appropriations processes.

We are sending copies of this report to the Chairman and Ranking Minority Member of the Senate Committee on Appropriations and its Subcommittee on Commerce, Justice, State, and the Judiciary; the Chairman and Ranking Minority Member, House Committee on Appropriations, and its Subcommittee on Commerce, Justice, State, the Judiciary, and Related Agencies. We will also send copies to the Chairman of SEC and will make copies available to others upon request. The report is also available at no charge on the GAO Web site at http:/www.gao.gov.

If you or your staff have any questions regarding this report, please contact me or Orice M. Williams at (202) 512-8678.



Richard J. Hillman, Director
Financial Markets and Community Investment

List of Requesters

The Honorable Michael G. Oxley
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The Honorable John J. LaFalce
Ranking Minority Member
Committee on Financial Services
House of Representatives

The Honorable Dan Burton
Chairman
The Honorable Henry A. Waxman
Ranking Minority Member
Committee on Government Reform
House of Representatives

The Honorable Paul Sarbanes
Chairman
The Honorable Phil Gramm
Ranking Minority Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Joseph Lieberman
Chairman
The Honorable Fred Thompson
Ranking Minority Member
Committee on Governmental Affairs
United States Senate

Appendix I: Scope and Methodology

To identify the existing self-funding structures used by Congress and the extent of control afforded to the appropriators under each structure, we interviewed officials from the Securities and Exchange Commission (SEC), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA) to obtain information on their budget structures and processes. Previously, we had discussed these issues with the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve System (FRS). In addition, we reviewed previous GAO work on the structure of other self-funded agencies, such as the Farm Credit Administration (FCA) and the Office of Federal Housing Enterprise Oversight (OFHEO). We then compared SEC's self-funding structure to that of other federal financial regulators and analyzed the degree of control afforded to the appropriators under each structure.

To determine the implications for SEC operations and congressional and executive branch oversight, we interviewed SEC officials regarding the impact of self-funding on SEC operations. We met with the SEC Chairman to obtain his views on self-funding. We interviewed financial regulators about the impact of self-funding on their respective agencies, and about the challenges and benefits associated with self-funding. We also interviewed representatives from the Senate and House CJS appropriations subcommittees, and officials from the Office of Personnel Management (OPM) and the Office of Management and Budget (OMB) to obtain their views on shifting budgetary control to SEC. Finally, we reviewed relevant GAO reports on SEC operations to identify existing issues.

We did our work in Washington, D.C., between February and July 2002, in accordance with generally accepted government auditing standards.

Appendix II: Comments from the Securities and Exchange Commission

THE CHAIRMAN

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

July 11, 2002

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

Re: Draft Report Entitled SEC Operations: Implications of Alternative Funding Structures

Dear Mr. Hillman:

Thank you for the opportunity to review and comment on the General Accounting Office's draft report addressing the implications of converting the Securities and Exchange Commission to a self-funded basis. The report, as required by the Investor and Capital Markets Fee Relief Act, discusses the various self-funding approaches that are available to other federal financial regulatory agencies and assesses the implications of giving similar authority to the SEC.

I believe strongly that self-funding authority is important to the future of the SEC. This authority would greatly enhance the ability of the SEC, as a regulator with oversight responsibilities over critical aspects of our nation's financial markets, to perform its statutory mission quickly, flexibly and effectively, particularly in times of rapidly changing conditions. In addition, in my view, the SEC is well suited to a self-funding structure, given that it currently collects fees from the securities industry that more than offset the costs of its operations. Moreover, I am confident that self-funding for the SEC can be structured in a manner that will preserve necessary accountability.

The report concludes that moving the SEC to a self-funding structure would have two primary consequences. First, the SEC would have more control over its own budget and funding level, which could give the SEC added flexibility to respond to workload challenges and market developments. Second, moving the SEC to a self-controlled funding structure could impact congressional and executive branch oversight. I agree that both budget flexibility and accountability must be considered fully in fashioning any self-funding structure for the SEC. The key, in my view, is to develop a structure that provides budget flexibility while maintaining agency accountability to Congress and the Office of Management and Budget. I am certain that there are ways to strike the right balance between these two objectives.

Mr. Richard J. Hillman
Page 2

While I agree that the report correctly identifies the principal consequences of converting the SEC to a self-funded basis, I am concerned with some of the report's analysis of the SEC's ability to address the issues that would arise if the SEC were given self-funding authority. For example, the report questions the SEC's ability to adequately manage annual fee collections to avoid shortfalls once the SEC is outside the budget process. This discussion could benefit from a more robust discussion of our responsibilities under the recently enacted Investor and Capital Markets Fee Relief Act. The Act significantly alters the process by which the Commission collects fees. In the past, the rates of fees required to be collected by the SEC were set by statute. As a result, the amount of fees collected in a given year varied according to market conditions. Now, the SEC has responsibility for adjusting fee rates on an annual and semi-annual basis, if necessary, to meet statutory "target offsetting collections amounts." In consultation with OMB and the Congressional Budget Office, the SEC developed an adjustment mechanism to perform this duty. This mechanism is precisely the type of mechanism that would be required if the SEC were to move to self-funding structure. In establishing the adjustment mechanism, we already have gained valuable experience in this area and will expand that experience with each mid-year and annual adjustment.

The report also notes that the SEC would need to improve its budget planning process if it were given self-funding authority. In support, the report describes the SEC's "reactive approach" to the annual budget process. As a general matter, however, the SEC's ability to be proactive with respect to budget planning is constrained by the requirements of OMB Circular A-11, and we will continue to be limited in the extent to which we can deviate from these requirements in the absence of self-funding authority. The SEC welcomes the opportunity to develop a more forward-looking, strategic budget process and indeed has become more proactive in certain areas. For example, even though the SEC is not covered by the requirements of the Chief Financial Officer Act and is limited by the lack of approved funding, the SEC supports the financial accountability goals of that Act and has begun to take the preliminary steps necessary to produce annual audited financial statements. I also intend to implement aggressive risk management and strategic planning that will affect all the agency's programs to help ensure that the SEC anticipates and plans for major market changes.

The report's discussion of the fiscal discipline that would be required if the SEC were given self-funding authority also would benefit from an analysis of the SEC's experience with unobligated balances. Since the early 1990's, the SEC has managed substantial amounts of available, unobligated balances derived primarily from fees collected in excess of amounts used to offset our appropriation. These balances have been applied judiciously by the agency in times of need to further our mission and have provided us with substantial flexibility to quickly respond to changes in the securities industry and our regulatory environment.

Mr. Richard J. Hillman
Page 3

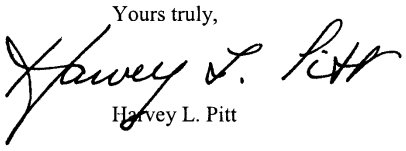
Our general policy has been to limit the application of these unobligated balances to specific, one-time purposes that require timely action. Recently, the SEC has used these funds to: 1) undertake our multi-year modernization of EDGAR, our real-time Electronic, Data Gathering, Analysis, and Retrieval System; 2) develop, in conjunction with the NASD, the Investment Advisor Registration Depository that electronically provides important disclosure information to the public; and 3) respond to the challenges that the Internet has brought to our enforcement program. On a more limited basis, and with the approval of our appropriators, we also have used a portion of these funds to add to our examination and inspection staff. Each of these undertakings shows that the SEC has the experience and ability to manage resources outside of the regular appropriations process. By not discussing our experience with these balances, I believe that the report's description of the implications of moving the SEC to a self-funding basis is incomplete.

With respect to congressional and executive branch oversight, the SEC currently works regularly and constructively with OMB and Congress, and we do not foresee that a move to a self-funding structure would jeopardize these important relationships. While self-funding would require us to develop some additional internal capabilities, we would continue to work with both OMB and Congress to ensure their involvement in our annual budget, strategic planning, management, and other operational activities regardless of our funding structure, much as the banking agencies do. As a uniquely positioned regulatory agency, the SEC fully appreciates both its independence and responsibility to exist within the larger federal framework.

In closing, the SEC's responsibilities have grown tremendously over the past decade as the securities industry has experienced unprecedented growth and change. Self-funding authority would give the SEC the ability to respond quickly and effectively to these dynamic changes. It also would provide us with a mechanism for further addressing our human capital challenges. As such, I believe that shifting the SEC to a self-funded basis -- much like our sister financial regulators -- is a laudable long-term goal that is worthy of further consideration and congressional support.

Thank you and your staff for the courtesy of allowing us to comment on your draft report.

Yours truly,



Harvey L. Pitt

Appendix III: GAO Contacts and Staff Acknowledgments

GAO Contacts

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Acknowledgments

In addition to the persons named above, M'Baye Diagne, Edda Emmanuelli-Perez, Denise Fantone, Edwin Lane, Barbara Roesmann, and Karen Tremba made key contributions to this report.

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