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Perspectives on the Securities and Exchange Commission's Budget

Statement of
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Committee on Banking, Housing and Urban Affairs
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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to participate in your hearings on the Securities and Exchange Commission's FY 1988-90 authorization request and its related FY 1988 budget request.

The Commission has requested the second largest budget increase in its 53-year history. There has been enormous growth in recent years in the securities industry as well as mounting concerns over the efficiency and fairness of the financial markets. At the same time, the Commission's resource levels have remained relatively constant. As a result, we and many people in the industry and the state regulatory commissions believe the Commission should be provided more resources.

But the ultimate question is: How much is enough? That is, what level of federal presence is necessary to accomplish the regulatory objective of responsible oversight and what are the resources that the Commission needs to provide such oversight? We cannot answer that question today. And, as far as we can determine, neither can anyone else. However, our overall impression is that even the 27-percent dollar increase, part of which would fund a 7-percent increase in staffing, may be insufficient to adequately oversee today's markets.

My testimony is divided into two parts. In the first part I would like to share with you our views about what information is necessary to provide a better basis for answering the question of how much is enough. In the second part of my statement I will offer our observations on the reasonableness of the areas of emphasis in the Commission's FY 1988 budget request in light of the varied and growing demands the agency faces.

DIFFICULTIES IN DETERMINING THE COMMISSION'S RESOURCE NEEDS AND MEASURING ITS ACCOMPLISHMENTS

Determining an appropriate resource level for the Commission is difficult, as is measuring precisely its accomplishments at given resource levels, because:

-- The budget documents themselves do not indicate what the Commission believes it should be doing to provide an effective level of oversight and, consequently, what its resource needs are.

-- The responsibility for effective oversight of the securities markets is shared jointly by the Commission and the industry itself. Any assessment of the Commission's needs must of necessity take into account the other resources that are applied to the oversight of markets. There are also differing perspectives on the balance of oversight responsibility that should exist between the federal government and the industry itself.

-- Measuring the Commission's program accomplishments is difficult because of the lack of data on how much violative activity exists in the market and the deterrent effect of the Commission's regulatory and enforcement efforts.

DETERMINING NEEDS

We found that, for the last several years, the Commission has not presented its long-term oversight goals and objectives for its major programs in its budget documents. Nor have these documents described the extent that the resources being requested will enable the Commission to achieve long-range goals and objectives.

In earlier years, the Commission did provide this kind of information as part of its budget presentations to the Congress. The FY 1980 budget request, for example, clearly stated the program goal, the long-range and FY 1980 objectives, and prior-year accomplishments for each major program. In addition, the budget estimate showed the impact of the resources being requested on the Commission's progress toward meeting its long-range objectives.

To illustrate, the Commission stated in its FY 1980 budget estimate that, as a long-term objective, it needed to conduct 2,650 investigations and complete 1,600 enforcement actions annually to preserve the integrity of the securities markets. The budget observed that the FY 1980 resource request would allow the Commission to conduct about 1,675 investigations and 850 enforcement actions. The Commission then pointed out that the requested level of resource application would permit no progress toward achieving its long-range enforcement objective.

The FY 1988 request does not identify long and short-range objectives for the enforcement program and thus it is unclear what the Commission believes it <u>should</u> accomplish and how far the requested resources will take it toward achieving whatever those objectives might be.

Similarly, the FY 1980 budget request showed that the Commission's long-range objective for the full disclosure program included the review of <u>all</u> new 1933 act registration statements in 20 days or less and <u>all</u> 1934 act annual reports in 270 days or less. The budget went on to describe what percentage of these filings the Commission could actually review with approval of its FY 1980 resource request and what progress it would thus make in achieving the long-range objective. Again, while the FY 1988 budget provides a good description of the program environment, by emphasizing the growth in filings and the percentage of filings that will be reviewed, it does not show clearly what the Commission should do in the filings review area to accomplish any specific disclosure goal or objective.

Stated simply, we believe the Commission's budgets should provide the Congress better insight into what the Commission feels it needs to accomplish, how much it expects to accomplish with the resources requested, and what is left undone.

SHARING OVERSIGHT RESPONSIBILITIES

It is a long established principle that the Commission shares the responsibility of assuring fair, orderly, and efficient capital markets with the industry's self-regulatory organizations (SROs). The Commission's mandate provides it with considerable leeway in deciding how strong a role it will play in overseeing markets. And, any decisions made in this regard have resource implications for the Commission.

There are two issues here. First, we are not certain about the level of market oversight the SRO's can effectively provide, given their own resource constraints and other inherent limitations. Second, we believe the Congress needs better information to gauge the appropriate level of direct federal oversight that should be provided in order to better determine the Commission's resource needs.

The Commission has increasingly shifted responsibility for maintaining effective market oversight to the SROs. We reported last September that oversight of SROs has generally worked well in the past. However, at that time, we observed that some Commission staff had misgivings about the SROs' capability to handle the added responsibilities. We reported that the SEC has substantially reduced its number of "cause" examinations (those involving an indication of some broker/dealer wrongdoing that the Commission thinks is serious enough to warrant looking into) by transferring this review responsibility largely to the SROs. In FY 1980 the Commission conducted about 500 such reviews and in FY 1988 expects to do 60. Some Commission staff were not sure the SROs had sufficient, experienced staff to conduct thorough broker/dealer reviews on time, and to handle all investor complaints, and other matters. We are not certain what level of oversight responsibility the SROs can handle effectively. But this is a question that must be answered in order to adequately define SEC's resource needs.

The second issue--what level of direct Federal oversight is appropriate--is of equal importance in eventually determining the Commission's appropriate resource level. In 1975, the Congress amended the 1934 Exchange Act to give the Commission additional authority over the SROs. But, as we reported last September, the Commission had rarely used its new powers, preferring instead to use a "give and take" approach resulting in negotiated solutions to deficiencies the Commission believes need correction.

Legitimate differences of opinion will always exist over the balance of oversight responsibility that should exist between the government and the industry. And the Congress' views on this matter have an important bearing on the Commission's resource needs.

MEASURING PROGRAM ACCOMPLISHMENTS

Finally, as with any law enforcement agency, the Commission faces a challenge measuring program accomplishments because there is no way of knowing how much violative conduct is occurring in the markets or the deterrent effects of oversight programs.

The insider trading problem illustrates this point. The Commission had increased its efforts to detect insider trading in the early 1980s. This increased vigilance was presumed to be having a deterrent effect on this kind of behavior. Then an anonymous tip led to the discovery of the current massive insider trading problem. Most observers were shocked and dismayed at the apparent magnitude of the problem and the fact that it had existed over so many years. This example serves to illustrate the difficulty of assessing the significance of the deterrent effects of the Commission's oversight and enforcement activities.

I would like at this point to turn to the details of the Commission's FY 1988 budget submission.

ANALYSIS OF COMMISSION'S FY 1988 PROPOSED BUDGET

The Commission's FY 1988 budget estimate totals $145 million and 2,086 staff years, representing a $30.5 million (27 percent) funding increase and a 136 (7 percent) staff year increase over the FY 1987 approved budget. We have some concerns about both the amount of the increase as well as its allocation.

CONCERNS ABOUT THE REQUESTED LEVELS

The requested increase for FY 1988 is part of a longer term effort to increase the Commission's resources from their current level of about 1,900 staff years to about 2,750 staff years in 1990. The authorization request containing this increase is based on contemplated changes in the regulation of financial services industry participants, market developments believed likely to occur in the future, and initiatives the Commission believes need to be undertaken. It does not appear to recognize the concerns that have been expressed by others over the growing disparity between the resources the Commission has devoted to oversight and indications of market expansion and complexity. We are currently working with your staff to further analyze the Commission's FY 1988 - 1990 authorization request.

During the 1980s the Commission has operated in an environment of growing markets and constrained resource levels resulting from budget austerity measures. Because of this, the Commission has had to alter its basic approach to regulation and oversight, becoming far more selective at what it does, assigning more work to the SROs, and attempting to automate many tasks previously performed manually.

The Commission has stated that because of its productivity enhancing initiatives, it has been able to keep pace with the growth in markets. However, we have questioned this view. Last August we reported that the numbers used by the Commission to demonstrate an increase in the productivity of its enforcement staff were not valid because the Commission's analysis treated all cases equally, regardless of their complexity. We are also currently analyzing the Division of Corporation Finance's selective review process to assess whether the targeting criteria used are identifying filings most in need of review.

In light of these considerations, it is useful to look at where the Commission expects to spend the increased resources that it is requesting for FY 1988.

CONCERNS ABOUT THE ALLOCATION

The Commission is requesting a 43 staff year increase and $19 million in expenditures for its full disclosure program. Of the increase, $15 million is designated for the agency's transition to EDGAR in FY 1988, and the other $4 million is for maintenance of existing staff. This project is designed to provide for electronic receipt, processing, and dissemination of corporate filings. In an earlier report, we identified issues that the Commission needs to resolve before it awards the EDGAR operational system contract. The Commission has recently agreed to take additional steps to address each of our areas of concern. While these steps should resolve the issues discussed in our report, we believe that they need to be completed prior to contract award so that the Congress can have sufficient information in deciding whether development of the operational EDGAR system should be authorized and funded.

We believe the Commission can justify an increase in staff years for the full disclosure program on the basis of the growth in number and complexity of corporate filings and its need to review some number of the filings to ensure proper financial disclosure. However, no increase is being requested specifically for the review of corporate filings, even though an increasing number of filings are unprocessed and thus receive no review. We reported last July that due to the increasing number and complexity of higher priority filings, there was a growing backlog of unprocessed 1934 Act annual financial reports. The Commission reviewed about 32 percent of these filings in FY 1983, and expects to review about 17 percent in FY 1988. While the Commission may review, but not count in its workload statistics, some of these reports in connection with its reviews of the companies' other filings, it does not plan to review and most likely will not review the vast majority of these filings.

The Commission plans to allocate an additional 55 staff years to the enforcement program in FY 1988. We believe the Commission can appropriately justify this allocation on the basis of substantial growth in market activity and the resulting possibilities of increased fraud. The Commission has stated that the incidence of securities law violations is proportional to the size and activity of the securities markets. The indicators of market growth such as the volume of trading, the broker/dealer population, and the number of securities industry employees all point to greater demands being placed upon this program.

The budget request also indicates an additional 10 staff years in FY 1988 for the market regulation program. The additional staff years will be used primarily to respond to new responsibilities, namely, the oversight of an anticipated 100-200 government securities broker/dealers as required in the 1986 amendments to the Exchange Act. No staff year increase is specifically provided in the FY 1988 budget to deal more comprehensively with the growth in the broker/dealer population from 6,730 in 1980 to 11,700 at the end of 1986. Although we do not know what increase is necessary for the Commission to effectively discharge its market oversight and regulation responsibilities, we believe the adequacy of the resources devoted to this area warrants further examination, particularly in light of concerns over the transfer of responsibility for broker/dealer oversight to the SROs that has been observed in recent years.

Finally, in the investment management regulation area, the Commission is asking for a 13 staff year increase. Again, we believe the Commission is justified in seeking this staff year increase on the basis of the significant increase in the number of investment companies and investment advisers, and the need to examine them with reasonable regularity. However, this increase may not be sufficient if the Commission is unsuccessful in adopting rules to exempt certain investment advisers from federal registration or if an SRO is not established to handle some of the oversight responsibility.

CONCLUDING REMARKS

I would like to conclude my remarks by summarizing the principal points of my testimony.

We find no reason to question the need for an increase in the Commission's resource level for FY 1988 and for future years. We cannot, however, affirm the appropriateness of the size of the increase or the exact allocation being proposed by the Commission.

We do observe, however, that the FY 1988 budget increase requested will not enable the Commission to handle its workload as it did in the late 1970s. Whether the level of oversight and resources that the 1980 Commission believed was necessary can serve as appropriate criteria for assessing the adequacy of today's oversight and accompanying resource needs is a matter of judgment. The Commission expressed concerns in its FY 1980 budget submission about whether its requested staffing was adequate to provide reasonable assurance of accomplishment of its mission. It seems safe to assert that, in view of the growth in market activity since 1980, the Commission's present resources and those proposed for FY 1988 would have been viewed as woefully inadequate by that earlier Commission.

Today's Commission believes that its selective approach to workload in many areas of its activities is enabling it to accomplish an adequate level of oversight. Whether the current approach is more successful, less successful or just as successful as the approach to oversight taken in 1980 is unclear. There is simply not enough information in the Commission's recent budget submissions to reach a conclusion one way or the other.

At present, neither we nor the Commission can determine precisely how much Commission oversight is needed in order to provide reasonable assurance that the markets are functioning in a fair, orderly, and efficient manner. We believe that in order to answer the longer term question of how much is enough, better insight on oversight needs and a linking of these needs with workload objectives and requested resources will be required.

We will continue to work with Subcommittee staff, as we have in the past several months, to assess the adequacy of the Commission's resources and, ultimately, provide the Subcommittee with a more informed basis for deciding "How much is enough."

That concludes my prepared statement. We would be happy to respond to any questions at this time.