FIXING THE WATCHDOG: LEGISLATIVE PROPOSALS TO IMPROVE AND ENHANCE THE SECURITIES AND EXCHANGE COMMISSION

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

SEPTEMBER 15, 2011

Printed for the use of the Committee on Financial Services

Serial No. 112–62

U.S. GOVERNMENT PRINTING OFFICE

72–603 PDF WASHINGTON : 2012

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

SPENCER BACHUS, Alabama, *Chairman*

JEB HENSARLING, Texas, *Vice Chairman*
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
RON PAUL, Texas
DONALD A. MANZULLO, Illinois
WALTER B. JONES, North Carolina
JUDY BIGGERT, Illinois
GARY G. MILLER, California
SHELLEY MOORE CAPITO, West Virginia
SCOTT GARRETT, New Jersey
RANDY NEUGEBAUER, Texas
PATRICK T. MCHENRY, North Carolina
JOHN CAMPBELL, California
MICHELE BACHMANN, Minnesota
THADDEUS G. McCOTTER, Michigan
KEVIN McCARTHY, California
STEVAN PEARCE, New Mexico
BILL POSEY, Florida
MICHAEL G. FITZPATRICK, Pennsylvania
LYNN A. WESTMORELAND, Georgia
BLAINE LUETKEMEYER, Missouri
BILL HUIZENGA, Michigan
SEAN P. DUFFY, Wisconsin
NAN A. S. HAYWORTH, New York
JAMES B. RENACCI, Ohio
ROBERT HURT, Virginia
ROBERT J. DOLD, Illinois
DAVID SCHWEIKERT, Arizona
MICHAEL G. GRIMM, New York
FRANCISCO “QUICO” CANSECO, Texas
STEVE STIVERS, Ohio
STEPHEN LEE FINCHER, Tennessee

BARNEY FRANK, Massachusetts, *Ranking Member*
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
MICHAEL E. CAPUANO, Massachusetts
RUBÉN HINOJOSA, Texas
WM. LACY CLAY, Missouri
CAROLYN McCARTHY, New York
JOE BACA, California
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
GWEN MOORE, Wisconsin
KEITH ELLISON, Minnesota
ED PERLMUTTER, Colorado
JOE DONNELLY, Indiana
ANDRÉ CARSON, Indiana
JAMES A. HIMES, Connecticut
GARY C. PETERS, Michigan
JOHN C. CARNEY, JR., Delaware

LARRY C. LAVENDER, *Chief of Staff*

CONTENTS

Page

Hearing held on:
September 15, 2011 1
Appendix:
September 15, 2011 67

WITNESSES

THURSDAY, SEPTEMBER 15, 2011

Atkins, Hon. Paul S., Visiting Scholar, American Enterprise Institute, and former Commissioner, United States Securities and Exchange Commission . 39
Crimmins, Stephen J., Partner, K&L Gates LLP, and former Deputy Chief Litigation Counsel, Division of Enforcement, United States Securities and Exchange Commission 41
Katz, Jonathan G. "Jack," former Secretary, United States Securities and Exchange Commission, on behalf of the U.S. Chamber of Commerce 43
Pitt, Hon. Harvey L., Chief Executive Officer, Kalorama Partners, LLC, and former Chairman, United States Securities and Exchange Commission 45
Schapiro, Hon. Mary L., Chairman, United States Securities and Exchange Commission 10
Saumya, Shubh, Partner and Managing Director, the Boston Consulting Group, accompanied by Michael Shanahan, Senior Partner and Managing Director, and Chandy Chandrashekhar, Managing Director 12
Verret, J.W., Assistant Professor of Law, Stanford University School of Law, and Senior Scholar, Mercatus Center, George Mason University 47

APPENDIX

Prepared statements:
Atkins, Hon. Paul S. 68
Crimmins, Stephen J. 81
Katz, Jonathan G. "Jack" 86
Pitt, Hon. Harvey L. 101
Schapiro, Hon. Mary L. 120
Saumya, Shubh 136
Verret, J.W. 141

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Atkins, Hon. Paul S.:
Addendum to his testimony 143
Schapiro, Hon. Mary L.:
Written responses to questions submitted by Representatives Schweikert and Grimm 147
Written responses to questions submitted by Representative Garrett 150

FIXING THE WATCHDOG: LEGISLATIVE PROPOSALS TO IMPROVE AND ENHANCE THE SECURITIES AND EXCHANGE COMMISSION

Thursday, September 15, 2011

U.S. House of Representatives,
Committee on Financial Services,
Washington, D.C.

The committee met, pursuant to notice, at 10:02 a.m., in room 2128, Rayburn House Office Building, Hon. Spencer Bachus [chairman of the committee] presiding.

Members present: Representatives Bachus, Manzullo, Biggert, Garrett, Neugebauer, McHenry, Pearce, Posey, Luetkemeyer, Huizenga, Duffy, Hayworth, Renacci, Hurt, Dold, Schweikert, Grimm, Canseco, Stivers; Frank, Waters, Maloney, Gutierrez, Watt, Sherman, Baca, Miller of North Carolina, Scott, Green, Perlmutter, Himes, and Carney.

Chairman Bachus. Good morning. The hearing will come to order. Without objection, all Members' written statements will be made a part of the record, and at this time, the Chair recognizes himself for an opening statement.

This morning, we will continue our examination of the Dodd-Frank Act. Section 967 of Dodd-Frank required the Securities and Exchange Commission to hire an independent consultant to examine the Commission's operations, structure, and need for reform.

The SEC hired the Boston Consulting Group to conduct the study, and the consultant's report was issued last March. The study and the report recognized that much needs to be done at the SEC to improve the effectiveness and efficiency of the organization, and I think that is a good starting point for this committee and Congress. I don't think there is an agreement on exactly what needs to be done when it comes to reforming the SEC, but all of us agree that the status quo is unacceptable.

I think all of you have the Boston Consulting Group's recommendations, so I won't go over that again. It was a three-step process. I will say that what I have introduced, and I think if you hear nothing else I say, hear this, it is not legislation. It was not introduced on the Floor of the House. It is a discussion draft. It is simply meant as a starting point for all of us to discuss various options.

I think there are probably two basic paths we can take, and I think both of them are very logical. One would be for the SEC to reform itself; physician heal thyself. I think that is a rational, appropriate approach.

Another approach would be legislation. A lot of Republicans and Democrats and others have said that before the SEC obtains additional funding, there need to be reforms. On the other hand, some of my colleagues have argued, I think with some persuasion, that with their expanded role, there is a need for an immediate funding increase, and in fact my personal view is that an increase in funding is probably necessary as part of the reform process.

We have tried—and I just had a discussion with the ranking member where he mentioned that five of the six witnesses were selected by the Republicans. We did that, but I will say this: We had witnesses—we invited witnesses who were on the record publicly saying, let the SEC reform itself. So we didn't try to invite witnesses who would come and agree with this discussion draft. In fact, some of our witnesses will—

Mr. FRANK. Mr. Chairman, yes, I acknowledge that, and I appreciate that. I was really talking about for the future. That is why we discussed it privately, not publicly. That was not meant as a criticism today, just a procedural for the future because I acknowledge what you just said.

Chairman BACHUS. I am going to introduce my written statement into the record, and I go into some more detail, but again, let me close by stressing that there is nothing sacred about this discussion draft. It is merely an attempt to start the discussion that I think we all agree—I know, Chairman Schapiro, you inherited an agency that needed reform, that I think acknowledged itself that there were inefficiencies. You also have inherited an agency that has been given vastly greater responsibilities, and with that in mind we will simply go forward, and I think that we can share the best ideas on both sides of the aisle and with the Administration.

And with that, I will recognize the ranking member.

Mr. FRANK. Let me ask that Mr. Scott be recognized first for 3 minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman. This is indeed a very important hearing and a very timely hearing, and I want to thank Chairman Bachus for this hearing today regarding proposals to reform the Securities and Exchange Commission. I certainly want to welcome Chairwoman Schapiro and the other gentleman, Mr.—I am afraid to attempt your name for fear I may hurt it a lot, but I will try—"Saumya."

As a result of the Dodd-Frank financial reform legislation that originated in this committee last year, the SEC was required to hire external consultants to examine its structure, operations, and funding. This was following, as we know, a lack of awareness by the SEC during the financial crisis of the dangers presented by the approval of subprime mortgages as well as inadequate supervision of the largest investment banks at this time.

Following a study, the Boston Consulting Group released its findings this past March, including recommendations for increased investment in infrastructure as well as reorganization of the SEC to increase its effectiveness and cooperation with other Federal agencies. But despite these findings, Chairwoman Schapiro has expressed a lack of resources available to the SEC to meet the majority of the Boston Group's recommendations. However, she has stated that some of the recommendations would be put into practice by means of some structural reorganization, so I am interested in finding out today what changes have been made and if the SEC is able to conduct any additional reforms in order to improve the Commission's effectiveness.

Let me just take a moment to talk about the need for these resources, particularly at this time when we are faced with the budget crisis, the debt crisis, the challenge to find \$1.5 trillion or \$2 trillion. We have to find a whole lot of money. So there is some thought about putting the increases that are needed on hold for the SEC; but let me point out that increasing the SEC's budget would not, and I repeat would not, have any impact on the deficit. And it is because of this reason: By statute, the SEC's transaction fees paid by Wall Street firms will be set to match the agency's appropriated funding levels, so cutting the SEC budget's request, it is important for us to establish today, will not help solve the Nation's debt problem. So we need to keep that in mind.

Furthermore, I anticipate the opportunity to discuss the legislative proposals that seek to overhaul the SEC's structure, including its ability to use reserve account funds and to lock the SEC structure into statute. We need to make sure that by proposing such legislation, we will still allow it to evolve with market changes, and that we are not preventing the SEC from conducting its intended purpose. This is indeed an important hearing. I thank you, and I thank the witnesses for coming.

Chairman BACHUS. Would the gentleman yield for 10 seconds?

Mr. SCOTT. Sure.

Chairman BACHUS. What the gentleman pointed out is that the SEC is funded by user fees, and I think that was an important distinction; that it is not, does not result in and contribute to a deficit or to the Nation's debt. And obviously, that is something we will need to consider if we determine that funding is necessary, which I think we all agree it is.

Mr. SCOTT. You are absolutely right, Mr. Chairman. Thank you.

Chairman BACHUS. Mrs. Biggert for 1½ minutes.

Mrs. BIGGERT. Thank you, Mr. Chairman, and good morning to the witnesses and thank you for being here. I look forward to hearing your thoughts on how we can improve what has been happening at the SEC to ensure that recent regulatory failures never happen again.

While the crisis exposed a systemwide regulatory failure, there is plenty of blame to be shared between the regulatory agencies, Congress, and the industry. Today, we are going to focus on the SEC, and Chairman Schapiro, I realize that most of all—that everything that happened was long before your time, and I certainly appreciate the Herculean task that you have been given. With Dodd-Frank having tasked the SEC with expansive new regulatory powers and responsibilities, I think that this is a heavy lift. And before the Commission undertakes these additional responsibilities over complex derivatives, hedge funds, and credit rating firms, I know that you have a lot of work ahead of you. So I am anxious to hear the Boston Consulting Group's recommendations, and, most importantly, I am anxious to hear from you, Chairman Schapiro, on the efforts taken to reform the agency and your strategy for overseeing the vast new responsibilities mandated under Dodd-Frank.

And I would also like to hear a little bit about what we have been asking the Department of Labor, to make sure that they worked with you and you worked with them. I know that you have been very accommodating that way, but I was very disappointed to see that the Department of Labor had come out with regulations, and you are still working on the study and everything, so I was very disappointed in what the Department of Labor has done.

With that, thank you again for being here, and I look forward to your testimony.

Chairman BACHUS. Mrs. Maloney for 1 minute.

Mrs. MALONEY. Thank you, Mr. Chairman, and Ranking Member Frank, for calling this very important hearing. And I welcome both of our panelists today. One of the important recommendations of Dodd-Frank was to have a review of how we could streamline, bring the SEC into the 21st Century, make it more effective because there are substantial new responsibilities given to the SEC.

I know that a later report will be coming out from the IG shortly, and I truly do believe that if this report is substantive, its detail can be a guidepost as we move forward with recommendations. But with the new responsibilities, the SEC needs the funding to get the job done while they are implementing these changes to be literally even more effective.

I was interested in one of your particular recommendations on evaluating nonperformance, the fact that there is no way to evaluate whether or not someone is actually responding to whistleblower complaints, how they respond to them, how they respond to industry, or really whether or not they are doing a good job for the SEC and for the government. But in any event, I congratulate the SEC, its report, their response, and the Boston Consulting Group, and I look forward to your testimony.

Chairman BACHUS. Thank you. Mr. Garrett for 1½ minutes.

Mr. GARRETT. Thank you, Mr. Chairman. Thank you for the witnesses here. We are looking forward to a good discussion on the operations and the effectiveness of the SEC.

I also wish to thank Chairman Bachus for allowing this committee today to consider the SEC Regulatory Accountability Act as part of today's proceeding. This is a bill that I introduced with about 14 of my colleagues to ensure that the SEC, basically being an independent agency, would be subject to the President's recent Executive Order to try to improve regulation and regulatory review.

In addition, what the bill would do is it would strengthen the Commission's cost-benefit analysis by: first, making sure there is actually a problem that the proposed regulations are trying to address; and second, requiring a cost-benefit analysis be performed by the SEC's chief economist. These are really basically commonsense reforms that make a lot of sense, I think, especially in light of how the Commission continues to seem to struggle with this issue.

For instance, in the recent unanimous opinion of the D.C. Circuit Court of Appeals, which vacated the Commission's proxy access rule, the court stated, "Unfortunately, the Commission acted arbitrarily and capriciously for having failed once again to adequately assess the economic effects of a new rule." And, "inconsistently and opportunistically frame cost and benefits of the rule."

So while I understand Chairman Schapiro may have concerns about this legislation, H.R. 2308, clearly a stronger commitment by the agency to a good cost-benefit analysis by the SEC I believe is essential. Why? To ensure that we do not unduly overburden registered companies or negatively impact job creation here in this country. I thank you and I yield back.

Chairman BACHUS. Mr. Himes for 2 minutes.

Mr. HIMES. Thank you, Mr. Chairman. And let me add my thanks to BCG and to Chairwoman Schapiro. I wanted to take my 2 minutes now, just to make a point that I think follows up on Congressman Garrett's point, because I hope that the regulatory agencies and that my friends in the Majority will think about cost-benefit analysis in this area in a slightly different way than they are.

I have been uncomfortable sitting here listening to a traditional way of evaluating cost-benefit analysis. And by the way, I fully buy into the notion that a rule's costs should match its benefit. As I thought about it, most of the regulation we do regulates activities that are a little bit predictable, that happen on a continuum, by which I mean if you decide to allow a little bit more particulate matter into the air, more kids are going to have asthma. You can predict that. Look, we will make a decision about how much of that we want or don't want. Motor vehicles, we will set a speed limit, and 40,000 Americans die on the roadways today, and that is a decision we have either implicitly or explicitly made around regulation.

The financial industry is different. We are talking about truly catastrophic events, if we get it wrong, that we have all lived through. And I am not sure you can analyze the cost associated with the incredible destruction of American wealth, and the millions of people out of work that happens when you get what the statisticians call a "tail event." It may not happen very often, but when it happens, it is devastating. This was understood by the Bush White House when they persuaded us into the Iraq War by holding up a picture of a mushroom cloud. Catastrophic event. It may be low probability, but you will do almost anything to avoid that event.

Now, I recognize that is not the best analogy, but it is not completely inapt. We should be prudent and do perhaps almost anything to avoid the destruction of household wealth that we saw in the meltdown. And by the way, we have seen them more often.

Chairman BACHUS. Another minute.

Mr. FRANK. The gentleman has another minute, I would add.

Mr. HIMES. Thank you. Since Glass-Steagall was weakened and a variety of our financial services regulations were lightened—and by the way, in some instances, they were good ideas, but starting in the 1990s, we saw emerging market crises in Russia in 1998 and in Mexico in 1994, the Internet bubble, and now truly the catastrophic tail event where Americans lost tens of trillions of dollars of wealth, and millions of Americans were thrown out of work partly because we got the regulation wrong.

So my plea is, let us not think about this like motor vehicle safety and speed limits or about particulate matter in the air which, by the way, we should debate. Let's think about this as being extra prudent, going the extra mile to avoid events which may be rare, although they are less rare now than they used to be, because when they happen, they are almost unthinkably catastrophic.

Thank you, I yield back the balance of my time.

Chairman BACHUS. Thank you.

Mr. Neugebauer for 1½ minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman, and thank you for holding this hearing. As we began to have this hearing today, I went back and reviewed some of the headlines for the SEC over the last few years: "Report Says SEC Failed in Oversight of Bear Stearns," that was The Washington Post; CBS News, "Court Documents Show How SEC Failed to Nab Madoff in 2006"; Washington Post, "Madoff Again"; CNBC, "SEC Ignores Complaints about Stanford"; ABC News, "How Big is the SEC's Porn Problem?"; New York Times, "SEC Hurt By Disarray in Its Books"; "Improvements Needed in SEC's Internal Controls and Accounting Procedures."

And so as we begin to have this debate, one of the things that Washington always seems to say is when we have deficiencies, we need more regulation, and we need more money. But really when you go back and look at a lot of the failures through the regulatory standpoint of the past crisis that we went through, a lot of those existing laws were on the books that would have prevented a lot of those events from happening. And so, I think one of the things that concerns me is that before we start doling out more money—some people say that doesn't create the deficit; it is a tax on the economy when you increase fees. But, before we go down that road, we need to make sure that we have regulators that are capable and structured to do their job before we expand that. And so I think we have to be very careful here of rewarding bad behavior with more money and more regulations.

I look forward to hearing from the witnesses today. Thank you.

Chairman BACHUS. Mr. Perlmutter for 1 minute.

Mr. PERLMUTTER. Thanks, Mr. Chairman. And I agree with Mr. Neugebauer; we have to make sure that what is on the books is enforced. Under the Bush Administration, there was very little enforcement, and so I do want to do the cost-benefit analysis for my friend from New Jersey, because between July of 2008 and January of 2009, the market dropped 6,000 points. It is $1.3 billion per point when the cops were taken off the beat, and we had a catastrophe, as Mr. Himes talked about. That is $7.8 trillion of wealth that evaporated. It was gained back with stronger enforcement. But for every man, woman, and child in America, that was $26,000 of wealth that evaporated in the stock market during that period of time. So now, let's try to do the cost-benefit analysis of that catastrophe.

Pretty much everybody has a 401(k) or a pension, so this affected a lot of people. And that is the reason for regulations and for the enforcement of regulations, which I hope that this SEC will continue to do. And with that, I yield back.

Chairman BACHUS. Thank you. Mr. Dold for 1 minute.

Mr. DOLD. Thank you, Mr. Chairman. I certainly want to thank Chairman Bachus and Subcommittee Chairman Garrett for their proposals to reorganize, improve, and reform the SEC. For decades, the SEC has been a critical factor in the historical success of our capital markets by helping to protect investors, to facilitate capital formation, and to promote transparent, fair, orderly, and efficient capital markets. But like every other regulatory agency, the SEC is not perfect, and the financial crisis manifested some of those imperfections. But even without the financial crisis, Congress should regularly review the SEC and other regulatory agencies to ensure that they are cost-effective, transparent, accountable, responsive, and efficient, especially in this constantly changing and competitive global marketplace.

Our regulatory agencies must have rational management and organizational structures; strong, clear, ethical standards; and effective checks, balances, systems, and controls. I am confident that all of us, Democrats and Republicans, market participants and regulators, share those objectives that will facilitate smart and cost-effective regulation.

And I look forward to hearing from our witnesses. Thank you, Mr. Chairman.

Chairman BACHUS. Thank you. Mr. Frank is recognized for 7 minutes.

Mr. FRANK. For as much time as I may consume—I don't know if a couple other of my Members may come. I have to confess, Mr. Chairman, my mind wandered for a bit when I was here. I was thinking of something else, and as I listened to my friend from Texas, I thought for a minute we were talking about the Pentagon when we were talking about not rewarding inefficiency with more money, and I got momentarily encouraged that maybe we would begin to think about spending constraints there.

But alas, I came back to this hearing, and the answer is, yes, you do want to make people be more efficient, but you don't penalize the American public further because agencies that were supposed to be protecting them didn't do the job well enough. And, yes, it is important to get more efficient; but, no, that is not in this case a substitute for funding when you are significantly increasing resources.

It is also the case that some of the inefficiencies resulted or some of the poor results resulted from ideological differences, from policy differences. The Boston Consulting Group, and I very much, Mr. Chairman, by the way—and I appreciate what you said about the hearing, and I think the witness list is a good representation. The reason I appreciated your comments is I think we should be trying to do both, which is to improve efficiency and deal with funding.

But let me just read a couple of things from the Boston Consulting Group's report: "Despite the material increases in responsibility driven by Dodd-Frank and the concomitant increase in workload, the SEC's resources have not grown in proportion." Next, and this is very important, on page 69 of the report, "While the SEC's funding has grown over the decades, in recent years the growth has not kept pace with the SEC's expanded role. Consequently, while the agency can certainly use its resources more efficiently, it still faces a resource disconnect," i.e., with the greatest affliction to the world, they wouldn't have the money to do what they are supposed to do.

And then on page 147, "While assessing which activities the SEC should undertake is beyond the scope of BCG's studies, senior management itself has identified several high-priority regulatory activities that it cannot implement today, even with the efficiencies described above." They cannot implement today, even with the efficiencies described above, including the agency's demand for technology and expertise. You can't "efficient" your way into modern technology and to getting the kind of personnel that you need. And, by the way, the BCG said, look, you are never going to have all the money in the world. Prioritize your activities.

So this is a reference to what would happen if they did do the prioritization. This is not saying, do everything. This says, after prioritization. And here's what the BCG says, not the SEC, but the Boston Consulting Group: "Based upon a very preliminary estimate, a range of an incremental $200 million to $300 million may be required for the initiatives described in choice one."

And finally, one of the options that some people have said they might do if they don't get the money is in the event that—this is on page 150—in the event that the funding environment does not change, an alternative option is the SEC's role to be changed to fit the budget. The SEC would then need to rethink what activities it should perform and delegate greater—I am sorry. It should then need to rethink what activities it should perform, delegate greater authority to SROs. The new SEC would change from being an actor that actively regulates markets and market participants to an overseer that primarily monitors the regulatory actions of others to whom it has delegated regulatory activity.

Let me just ask you in terms of time, is that based on 5 or—

Chairman BACHUS. The gentleman can have another minute.

Mr. FRANK. I will just finish with this. I will just take 1 more minute. There is one major additional responsibility that I believe is very important. That is the shared responsibility with the Commodities Futures Trading Commission over derivative regulation. Among the mistakes that were made by Congress and the President earlier, around 2000, when derivatives were exempted from regulation, when the swap market grew up. So the swap market grew up in an area, in fact it is not even correct to call it deregulation, it is nonregulation of a very important activity.

We have given the SEC, along with the CFTC, the responsibility to regulate derivatives. We are talking about AIG, we are talking about interchanges between financial institutions, not so much end users. The notion that they could take on that added responsibility is a very complicated one. We want it done right. Derivatives is a complicated business, and we don't want to impinge on end users. To do that without a significant increase in funding is clearly impossible.

So I welcome the Boston Consulting Group. They argue that we may have been overly prescriptive in the legislation last year, and I am open to that. I think that is one of the things we may be able to agree upon, Mr. Chairman, about giving them more flexibility within the context of assuring these things. But let's be very clear. We have a major new grant of responsibility in derivatives, and the notion that can be done without a significant increase in funding is greatly flawed.

Thank you, Mr. Chairman. I will reserve the balance of my time.

Chairman BACHUS. At this time, Mr. Canseco for 1 minute.

Mr. CANSECO. Thank you, Mr. Chairman. According to the SEC's Web site, their mission is to protect investors, maintain fair, orderly, and efficient markets, and to facilitate capital formation. In order to carry out this mission for Fiscal Year 1999 through Fiscal Year 2010, the SEC's annual budget tripled from $340 million to $1 billion. Looking back over those years, one can't help but think of the words Enron, WorldCom, Madoff, Stanford, and Lehman. The recent failures of the agency were not due to the lack of funding or authority. They were due to poor communication and bureaucratic roadblocks that resulted in billions of dollars of losses for innocent investors, essentially regulators asleep at the wheel. The old-fashioned solution is to throw more money at the problem and hope it goes away, but more money doesn't solve inefficiency. Only a serious reform can fix the SEC.

I look forward to today's hearing on this important topic and commonsense measures introduced by Chairmen Bachus and Garrett. Thank you.

Chairman BACHUS. Ms. Waters for 2 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman, for holding this hearing this morning on the future of the Securities and Exchange Commission. I am very interested to hear how the SEC is moving forward to implement the recommendations outlined in the Boston Consulting Group report. As you know, constructive organization reforms at the SEC can help to increase the Commission's effectiveness, but of course we cannot overlook the fact that despite pursuing greater efficiencies, the SEC continues to be underresourced by the Congress, and that ultimately undermines their effectiveness.

I also wanted to note my concerns about Chairman Garrett's legislation, which seeks to subject the SEC to very onerous cost-benefit tests when not only issuing new rules but also enforcement orders.

First, the SEC already has to consider what impact any rule or regulation would have on efficiency, competition, and capital formation before issuing it, so this bill is redundant. This is evidenced by the fact that the D.C. Circuit Court of Appeals recently struck down the SEC's proxy access rule on the grounds that it contained an insufficient cost-benefit analysis. Clearly, the SEC is already held to a high standard by the court.

Second, I am concerned that Chairman Garrett's bill would conflict with the SEC's mission. The bill almost exclusively focuses on limiting burdens on the market and puts no emphasis on protecting investors.

Finally, I am concerned that enforcement actions could now also be subject to a cost-benefit analysis. I feel this would be inappropriate. Enforcing securities laws should be a matter of protecting the rule of law, plain and simple.

I am also concerned about Chairman Bachus' draft legislation which would enshrine in law an organizational chart for the SEC. I am concerned about whether the SEC would be able to respond to rapidly changing capital markets under the provisions set forth in this bill.

Mr. Chairman, I would hope that we have a bipartisan effort to support the SEC in ways that will allow them to do their job and protect the investors and the consumers. And I would hope that we would just give them the opportunity to do what they have to do and to realize their mission.

I yield back the balance of my time.

Chairman BACHUS. Thank you.

At this time, we have votes on the Floor. We are told it is going to be about 45 minutes, so we will return at the end of that time. We have 3 minutes left on our side. I am simply going to say this: We talked about funding, and as one Member said, "If it is a user fee, it is a tax on the industry. If it is an appropriation, it does affect the deficit."

That is another decision that Congress needs to make as to how the SEC is funded. I think most of my colleagues in the past have supported user fees, but at the same time, some have stressed that Congress needs to maintain at least some review by the appropriators. So that would obviously be a discussion we would also have.

Another thing I think we all need to acknowledge is that we do have a law in place, Dodd-Frank. We have different views on different provisions of that law, but it is a reality, and statutorily the SEC is charged with implementing that Act. And so, those are things that have to be factored in. And I do acknowledge that the Boston Consulting Group did say that additional funding was necessary. I am not going to argue with what is in print. Thank you.

We will recess at this time.

[recess]

Chairman BACHUS. The committee will come to order. At this time, I would like to introduce the two witnesses from the first panel: the Honorable Mary Schapiro, Chairman of the U.S. Securities and Exchange Commission, who was not there during Madoff; and Mr. Shubh Saumya, partner and managing director of the Boston Consulting Group. Mr. Saumya is accompanied by Michael Shanahan, senior partner and managing director, and Chandy Chandrashekhar, managing director. They will participate in the question-and-answer session, but will not give an opening statement.

I welcome our witnesses.

So at this time, Chairman Schapiro, you are recognized for your opening statement, which you don't have to limit 5 minutes. You have the discretion to get yourself in as much trouble as you need. No, I am kidding. Thank you.

STATEMENT OF THE HONORABLE MARY L. SCHAPIRO, CHAIRMAN, UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Ms. SCHAPIRO. That is very good advice, Mr. Chairman. Thank you, Chairman Bachus, Ranking Member Frank, and members of the committee.

Thank you for the opportunity to discuss the organizational assessment of the Securities and Exchange Commission performed by the Boston Consulting Group and other issues regarding the SEC.

When I arrived at the SEC 2 years ago, the agency was reeling from a variety of economic events and mission failures that had severely harmed the ability of the agency to—we acted swiftly and comprehensively to reform the way the Commission operates. We brought in new leadership in virtually every office, including the Commission's first Chief Operating Officer and first Chief Compliance Officer. We revitalized and restructured our enforcement and examination operations, revamped our handling of tips and complaints, took steps to break down internal silos and create a culture of collaboration, improved our risk assessment capabilities, recruited more staff with specialized expertise and real-world experience, expanded our training programs, and enhanced safeguards for investors' assets through new rules and by leveraging public accounting firms.

Our goal, throughout these many changes, has been to create a more vigilant, agile, and responsive organization to perform the critical mission of the agency. I believe our efforts are paying dividends. Last year, the SEC returned $2.2 billion to harmed investors, twice the agency's budget for that year. And last fiscal year as well, $2.8 billion in disgorgement and penalties were ordered in SEC enforcement actions, a 176 percent increase over the amounts ordered in Fiscal Year 2008. We have brought enforcement actions ranging in scope from complex cases against parties that have played significant roles in the recent economic crisis to lesser known cases involving real harm to individual investors. Our examiners and enforcement investigators now collaborate frequently and effectively, resulting in a number of recent enforcement actions generated from exam referrals. We are proud of our progress but we continue to seek ways to improve our operations.

Last fall, as required by the Dodd-Frank Act, the SEC engaged the services of BCG, a top tier organizational consulting firm with significant capital markets expertise to conduct a broad and independent assessment of the SEC's organization. It was gratifying that BCG confirmed what we believed, that over the past 2 years, the SEC has improved the effectiveness of its operations. Nevertheless, we agree as well with BCG that the SEC still has significant opportunities to further optimize its available resources.

However, even assuming further optimization, BCG still concludes that the SEC will not have the personnel resources to perform all the activities that are within the agency's responsibility. BCG also concludes that insufficient resources have contributed to a gap in the SEC's ability to develop needed information technology systems. Beyond the resource issue, BCG provided useful insights into how the SEC might continue its efforts to ensure that it remains a vigilante, agile, and responsive organization. Given the broad scope of the BCG reports recommendations, determining and executing the appropriate course of action will require careful internal coordination and a significant commitment of staff and other resources. That process has already begun. We have organized our work streams around four principle goals: optimizing the agency's mission and structure; strengthening capabilities; improving controls and efficiencies; and enhancing our workforce.

In addition, we have already implemented or are in the process of implementing a number of BCG recommendations, including clarifying the role of the Chief Operating Officer and enhancing his ability to make needed changes, build in high priority staff skills, establishing a continuous improvement program, improving the Office of Administrative Services, optimizing the organizational design of the Office of Information Technology, redesigning the Office of Human Resources, and prioritizing among the many SEC responsibilities. As we move forward, however, it is important to note that BCG believes that substantial up-front investments will be required to implement its recommendations.

While some portion of these costs can be paid for through the efficiency gains outlined in the report, those savings will not be sufficient to cover the full investment needed to achieve our goals. In addition to the report, the committee has requested my views on two pieces of legislation, the SEC Modernization Act of 2011 and the SEC Regulatory Accountability Act.

Although I appreciate the intent of both bills, my written testimony describes some significant concerns with regard to these bills' impact on the agency's structure, and our ability to flexibly respond to changing market conditions as well as our ability to police the financial markets. For example, the Regulatory Accountability Act requirement for cost-benefit analysis of all SEC orders could undermine our ability to issue enforcement orders against wrongdoers, delay exemptive orders needed to facilitate the introduction of new investment products to the market, and impede the capital formation process by delaying orders to companies that accelerate registration of their securities. I would welcome the opportunity to work with the committee on both pieces of legislation to ensure any legislation truly improves the SEC's ability to achieve its mission.

The SEC recognizes that implementation of many of the ideas in the BCG report will require a long-term commitment and sustained effort over several years to successfully implement. While we are still in the early stages of implementing the recommendations, we are committed to an open and transparent process. Thank you again for the opportunity to testify, and I am, of course, happy to answer any questions you may have.

[The prepared statement of Chairman Schapiro can be found on page 120 of the appendix.]

Chairman BACHUS. Thank you.

Mr. Saumya?

STATEMENT OF SHUBH SAUMYA, PARTNER AND MANAGING DIRECTOR, THE BOSTON CONSULTING GROUP, ACCOMPANIED BY MICHAEL SHANAHAN, SENIOR PARTNER AND MANAGING DIRECTOR, AND CHANDY CHANDRASHEKHAR, MANAGING DIRECTOR

Mr. SAUMYA. Chairman Bachus, Ranking Member Frank, and members of the Financial Services Committee, my name is Shubh Saumya, and I am a partner and managing director at the Boston Consulting Group. In my capacity as the partner responsible for leading the BCG team that conducted this review, I am pleased to appear before you this morning on behalf of BCG to discuss the report that BCG completed concerning our organizational and operational review of the U.S. Securities and Exchange Commission. As this was a significant undertaking involving many BCG professionals, I am accompanied by two of my colleagues who will be able to assist in responding to your questions, Chandy Chandrashekhar, who was responsible for the IT review, and Michael Shanahan, who was responsible for the organizational and people review.

Our study of the SEC was conducted pursuant to Section 967 of the Dodd-Frank Wall Street Reform and Consumer Protection Act and resulted in a 263-page report which we delivered to Congress and the SEC on March 10, 2011. We leveraged a number of proprietary methodologies and tools, reviewed extensive documentation, undertook analysis, and conducted more than 425 discussions with current and former SEC officials, regulated entities, peer regulators, self-regulatory organizations (SROs), and industry groups. We focused on the four subjects that the SEC identified in the statement of work for this project: first, organizational structure; second, personnel and resources; third, technology and resources; and fourth, relationships with self-regulatory agencies, or SROs.

To carry out its mission, the SEC requires both a regulatory framework with clear authorizations as well as a robust set of internal capabilities to fulfill its mandate. Our study focused on the latter. We found that while the SEC has initiated steps to better fulfill its mission as well as its expanded mandate under Dodd-Frank, the agency can do more to shape a more effective organizational structure and to address capability gaps we identified.

To this end, we developed a portfolio of initiatives which will create real efficiency and effectiveness improvements for the agency. We recommended that the SEC implement these initiatives immediately and rigorously on a "no regrets" basis because they are foundational to the agency's future. These initiatives fall into four major categories and are as follows: First, reprioritize regulatory activities. The SEC should engage in a rigorous assessment of its highest priority needs in regulatory policy and operations and reallocate resources accordingly. Second, reshape the organization. The SEC should reshape its organizational structure, roles, and governance to maximize efficiency, effectiveness, and collaboration as well as to drive continuous improvement. Third, invest in enabling infrastructure. The SEC should invest in key enabling infrastructure, including technology, human resources, risk management, and high priority staff skills.

And finally, enhance the SRO engagement model. The SEC should implement initiatives to enhance its role as both an overseer of and co-regulator with SROs. In our report, we outline an implementation plan for these initiatives that carefully sequences them in a way as to create significant efficiencies that would help fund the investments and capabilities called for in the plan. As an initial matter, we recommended that the agency create a project management office to coordinate the immediate implementation of the recommended initiatives.

We also recommended that after the SEC has implemented these initiatives, Congress should reflect on whether or not the resulting organization adequately meets its expectations for the agency's efficiency and effectiveness. If Congress determines that the optimization still does not meet its expectations, then we recommend that it consider either increasing funding to allow the SEC to better fulfill the current role, or changing the SEC's role to fit available funding. We have reviewed the draft bills you will discuss today. The proposed SEC Modernization Act of 2011 contains a number of provisions which, based on our reading of the draft bill, appear to be consistent with options outlined in our report.

Moreover, there are several provisions of the Modernization Act which appear to posit actions beyond those outlined in our report. In addition, several provisions of the Act appear to go beyond the scope of our study. The other proposal, the SEC Regulatory Accountability Act, H.R. 2308, addresses regulatory mandates that are beyond the scope of our study. Again, thank you for your time and attention. My colleagues and I are happy to answer any questions that you may have.

Chairman BACHUS. Thank you.

[The prepared statement of Mr. Saumya can be found on page 136 of the appendix.]

Chairman BACHUS. Mr. Saumya, what do you think would be the number one structural change that ought to be made at the SEC? And should it be made before additional funding or additional staff hires? Or what should that sequence be?

Mr. SHANAHAN. There are a number of structural recommendations that we have made which we consider that it should implement, but we gave several choices for those. One of them was, of course, the relationship of IM and TM, and the issue of the challenge of market dynamics having made broker-dealers and investment advisers more similar in the approach rather than dissimilar, and having two separate divisions dealing with that posed challenges around information and best practice sharing.

Chairman BACHUS. In that regard, would we first need to settle the question of who is going to be the primary regulator over the investment advisers?

Mr. SAUMYA. We did note that there is a lot of dialogue on that topic of harmonizing investment adviser and broker-dealers exam. In the set of options that we identified, one option got to a structure that assumes that you have resolved that. But clearly, as an input to finally deciding the right structure, a resolution on that would be important.

Chairman BACHUS. I think they could be combined irregardless because I think the SEC would continue to have oversight and accountability, even if you had an SRO or something.

Mr. SAUMYA. Yes. Because the SEC would have to oversee the SRO in a very robust manner.

Chairman BACHUS. That is right. Thank you.

Mr. SHANAHAN. And the second major structural option that we said was how to organize the exam, and there are pros and cons on either side of how the exams should be organized. Right now it is a separate office, as you are aware. And we have pointed out that that has its pluses and minuses. In the recent past, it has had several pluses by raising the standard of exam and the consistency of the exam and having won individual accountability for prioritizing an exam. There is also potentially an added advantage of it being independent from enforcement—independent so that it is not necessarily a slave to enforcement, as it were.

The cons, however, are clear as well. Separating exam from divisions means that you lose the possibility of information flow between the two. Not only do you need that operationally, but you need that for learning. Exam can feed back to rules, and rules can transfer to exam much more seamlessly if they are together. And second of all, there is some career mobility if you combine the two that is lost if you separate the two.

Chairman BACHUS. Thank you. Chairman Schapiro, you have had the report since March. I am sure you have reviewed it. Has the agency undertaken any of the recommendations to date?

Ms. SCHAPIRO. Yes. We have, Mr. Chairman, undertaken quite a few of the recommendations. Understandably, a lot of these involve a longer-term process because some of the recommendations are really quite massive. And so, on top of all the other work the SEC is engaged in, it will take us some time. But we have already consolidated the Office of the Executive Director under the Office of the Chief Operating Officer and have eliminated the Executive Director. We have established a continuous improvement program to look for cost savings wherever we can in the agency so that we can redeploy those savings to other activities. That is savings in terms of programs and operations. We are in the process of training all of our employees for a full rollout of our new performance management system, which was highlighted by BCG.

We have reorganized the Office of Information Technology with new leadership, and that is starting to yield dividends as well. And we have begun the full review of the design and the structure of the other infrastructural parts of the agency, including the Office of Administrative Services. That work should be done in November and then we will be able to go forward with it. In addition, we have offloaded some responsibilities that we think can be done more efficiently by outsourcing to agencies.

So as you well know, our financial management program is being outsourced to a Shared Federal Service Provider, the Department of Transportation, and all of our leasing activity is being outsourced to the General Services Administration. We have also, as you know, reorganized enforcement to great result, I believe, reorganized the examination program, and the other more workstreams that I mentioned are well under way with respect to the other recommendations.

Chairman BACHUS. Thank you. And the ranking member is recognized for 5 minutes.

Mr. FRANK. Thank you, Mr. Chairman. Let me say—and you have been very reasonable here. As I listen, I am now prepared to reconsider the extent to which we were as prescriptive as we were last year in the bill with regard to the SEC. I think one of the things that we can perhaps work together on is to find ways to convey our sense of the importance of particular activities without necessarily having a separate entity. One, for example, that I know you have been very concerned about, we have the whole municipal securities issue. We clearly believe that municipalities have been badly treated by this system. By the way, with regard to the ratings agencies, which we will get back to, they are extraordinary. They managed to be very wrong in two different directions. These are people who have systematically overrated private securities but systematically underrated public entities. I am not now talking about the United States. I am talking about State and local government, full faith and credit, general obligation bonds which never default.

Moody's threatened to downgrade some AAA communities that I represent. I asked them why, and they said, "We are not saying that they are going to default. We are saying that they are more likely to default than some others." That is kind of like saying, if you live in Iowa, you have more chance of being eaten by a shark than if you lived in Montana. That might be statistically the case. Neither one would be relevant to any rational human being. And we have had the problem of the municipalities under fiscal stress being misadvised.

We did enhance the fiduciary responsibility of advisers. But setting up the office may have gone too far. So I am prepared to work with the chairman and work with the agency and find out if there are ways that we can make sure we have enhanced the importance.

Now let me ask you, Chairman Schapiro, in the bill by Mr. Garrett, H.R. 2308, on raising the bar for adopting regulations, there are two points that occurred to me. One, Mr. Pitt, in his testimony, makes a very interesting point that we should not be telling you to decide whether or not to do things that we have told you you have to do, that it is appropriate for you to decide how to do them. But if you read the bill, it would give the SEC the option of deciding to ignore a congressional mandate, and that obviously would have to be fixed. More seriously—maybe harder to fix. I take that back—maybe perhaps more intended is this reference in the bill to saying that it covers not just regulations but orders. And it says, before you could issue any order pursuant to such laws and any intended regulation or order, etc.—am I correct, would that mean that an enforcement order would have to go through a cost-benefit analysis? What would that language mean for you in terms of enforcement?

Ms. SCHAPIRO. Congressman, I think as we read the bill, it would require a cost-benefit analysis for enforcement orders which would obviously have huge implications for our prosecution of securities fraud. But also, for exemptive orders that we utilize to enable industry to bring products to market more quickly. Exchange traded funds, for example, operate by virtue of exemptive order from the Investment Company Act. Orders to accelerate the registration of securities—

Mr. FRANK. I appreciate that. But again, particularly I have to say with regard to enforcement, the notion that before you could issue an enforcement order, you have to do a cost-benefit analysis seems to me really quite odd.

Ms. SCHAPIRO. I think it would be very damaging to the enforcement program.

Mr. FRANK. All right. Let me just go now to Mr. Saumya. And I really appreciate the quality of the report and the way in which you have presented it. Am I correct that what you are saying is that, yes, there are ways to be made more efficient and some choices, but if you are going to continue with major new responsibilities—and the biggest single responsibility, it seems to me, we gave the Commission last year was derivatives, particularly swaps which have previously been exempted. Is there any way for them to take on the new responsibilities regarding swaps without an increase in the appropriation, no matter how much efficiency improves?

Mr. SAUMYA. As we described in the report, Congressman, as the SEC is currently constructed and given the productivity of its resources, the added workload clearly leaves them a capacity gap. We also identified a series of initiatives which we recommended the agency immediately adopt which will create efficiencies and restructure the organization in a way that will clarify roles and improve productivity. This will go some way towards addressing the capacity gap that has been identified. The challenge to know precisely how far it will go is that the need is determined by the regulatory agenda that you all have.

So there is the swaps issue that you raise. But there are other sets of issues, for example, the investment adviser exam. That is a big issue. And depending on where the Congress and the agency determines, whether it should be increased, how much they should be increased has a very material impact on the actual resource need.

Mr. FRANK. By "capacity gap," you mean not enough money, is that correct?

Mr. SAUMYA. Capacity gap, money—yes.

Mr. FRANK. Let me just say, my last point, as I read all the testimony—I may not be able to come back to Commissioner Atkins. He had one thing in there in which he talked about how much more logical it would be if we were—and better if we would be able to merge the SEC and CFTC, to which I can only say, I wish. If I was making a new country, there would be one such entity. But unfortunately, interests do vest.

So I will say yes, you are right. But unfortunately, that is a little beyond us. And let me also say, in anticipation, I did appreciate former Chairman Pitt's reemphasis of the importance of a self-funding operation. That is something that is within our grasp. And I think that got defeated, frankly, by turf. It was the fact that the Senate appropriators felt so strongly about that, that we lost it. I am hoping we can get back to that. And I think Mr. Pitt is right, there are ways to make that conform to oversight. Thank you for your indulgence, Mr. Chairman.

Chairman BACHUS. I thank the ranking member. Our staff is working on the shark question, and they have determined that it would be a long freshwater swim either way.

Let me ask for a clarification. You are saying in the Garrett amendment, it asks for cost-benefit analysis even before a rule is proposed?

Mr. FRANK. As I read the bill—I am on page 2—"before promulgating a regulation under the securities laws, as defined in section 3, or issuing any order pursuant to such laws, the Commission shall" and it does all of those things.

Chairman BACHUS. Yes, and before it proposes.

Mr. FRANK. Yes.

Chairman BACHUS. So that would be tough to do. I may have to take another look at revising that.

Mr. FRANK. I think the cost-benefit analysis of following this bill—

Chairman BACHUS. I would like to make an announcement before we move on. Mr. Miller has asked that the 2:00 hearing be postponed and the two witnesses have agreed. There were only two witnesses at that hearing. So the International Monetary Policy and Trade Subcommittee will hold its hearing to examine the impact multilateral development banks have on America's national security at a later date, September 21, 2011, at 2:00 p.m. So that has been rescheduled. With that, Mrs. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman.

Chairman Schapiro, I hope I am not off message with this hearing. But I did want to go back to the study that Dodd-Frank required the SEC to—one of the issues, and that was to study the current standard of care for broker-dealers and investment advisers. I know that you released the study. I am not happy with the outcome of that. And that was to harmonize the different standards that currently exist. Can you point to any economic research or analysis that shows the need for this harmonization?

Ms. SCHAPIRO. Congresswoman, as you know, the study itself did go through some economic analysis and we did seek data from commenters about that. We would normally provide our economic analysis when we proposed a rule which we have not done in this context. While the staff is thinking through what the contours of a rulemaking might look like, and are continuing to meet with industry and investors who have interests in it, we have also asked our economists to gather whatever data is available to help inform that discussion and that rule-writing process. But we have not yet proposed to go forward with a specific rule at this time.

Mrs. BIGGERT. There has been talk about—because so much is involved—to have assistance in the examination and oversight of investment advisers, and it has been suggested that there be SROs, such as FINRA. Of course, you are very familiar with FINRA. Would this be something that you think would happen?

Ms. SCHAPIRO. I didn't participate in the staff's study because of my affiliation with FINRA. I was under the 2-year recusal period at that time. The staff laid out three alternatives. I think we can all agree that covering or examining 9 percent of investment advisers, that hold $43 trillion worth of assets, a year really isn't sufficient. So the staff's alternatives were that there be a fee mechanism for advisers to pay for the SEC to be able to examine them, that FINRA be given the authority to do at least the examination of duly registered broker-dealers and investment advisers, or that there be an SRO created.

I think unless there is sufficient funding for the SEC to do this, we have to look very seriously at an SRO. Whether it is FINRA or not is a question I would not address. But I think we have to find a way to have better oversight of intermediaries who have such enormous interplay with retail investors, and an SRO is one of the vehicles to do that.

Mrs. BIGGERT. And despite your efforts to study, I was concerned that the Department of Labor then unilaterally moved to publish a rule that could conflict with any new standard that your Commission might propose. I know that there was some talk about at least getting together and working together, so I was really surprised that the Department of Labor came out ahead of what you had decided. And I don't know that there was any real coordination or conversations. I know that you tried to get together, but is this going to be a problem?

Ms. SCHAPIRO. We reached out to the Department of Labor. We had a number of conversations. We participated in some of their roundtables. But at the end of the day, they have responsibility for the administration of ERISA and the definition of fiduciary under ERISA. The SEC doesn't have that responsibility. We did make clear in our study that when we talk about fiduciary duty in the context of investment advisers, it is not with regard to ERISA standards.

Mrs. BIGGERT. Thank you very much. I yield back.

Mr. SCHWEIKERT [presiding]. The gentlewoman from New York.

Mrs. MALONEY. Thank you for your testimony and for your report. I would like to ask Mr. Saumya, in BCG's report, your preliminary estimate of needs ranged from $200 million to $300 million and your report estimated a shortfall in staff needed to fulfill the current mission of 375 to 425 full-time equivalents. And yet we are all aware that the funding level proposed by the House is $1.185 billion for Fiscal Year 2012. So my question is, did your study or did BCG consider the effects of limiting the SEC's budget to $1.185 billion when conducting the analysis and recommendations?

Mr. SAUMYA. As we looked at the SEC, as currently constructed, we analyzed the workload and said, there is a capacity gap. Having recognized that, we then laid out a set of options and implementation plans against that. That will create material efficiencies at the agency, which should help address part of this capacity gap. We also recommended that given the circumstance, the agency should look very hard at its regulatory activities and reprioritize its resources to the most important activities that it is doing, and transparently engage in a dialogue with Congress to indicate what activities it will have to scale back or stop in order to redirect resources to higher priority activities.

Mrs. MALONEY. So you did not recommend what they should not do since there is quite a gap when you need $200 million to $300 million to do the job, as you estimated, and roughly 400 additional people to do the job. That is quite a gap. I would like to ask Ms. Schapiro and Mr. Saumya, how will investor protections be impacted by the funding proposal or the cap of $1.185 billion when the Boston report says that you need $300 million to $400 million more to get what is required to do the job? Did you do an investigation of how investor protections will be impacted by this cap that limits the number of people you can hire and limits really the resources that are in front of you?

Clearly, you have more to do than the resources that are there before you. So Mr. Saumya, did you look at how it will impact investor protections, the fact that the money is not there, the personnel is not there by your own report, by the facts?

Mr. SAUMYA. Since we left it to the agency to determine and reprioritize their activities, depending on what they choose to emphasize and what they choose to scale back, that would have to furnish an impact. So the agency is best suited to address that question. If I may just go back to the point that was made earlier, the

$200 million to $300 million that was talked about includes a lot of capital spent for technology, which is a one-time spend, not a budget increase, because that then sets up a lot of productivity opportunities at the agency, which is how it should be.

Mrs. MALONEY. Did you break that down in the report, how the $200 million to $300 million should be spent?

Mr. CHANDRASHEKHAR. We identified a number of areas where money will have to be spent somewhere, would have been in technology, personnel and others, specific upgrades that are needed to be made to individual systems and capabilities.

Mrs. MALONEY. That would be helpful, I think, if you gave us a clear breakdown of capital versus resources. And so then, let me turn to Ms. Schapiro. How will investor protections be impeded by a funding level proposed by the House that is $1.185 billion, even though your responsibilities have grown, I don't know how many times more, twofold, threefold, fourfold?

Ms. SCHAPIRO. Our responsibilities have grown dramatically. And I would say that while we are engaged in this process of looking at how we prioritize what we do, our responsibilities are a result of Congress making decisions over many years about what is important for this agency to do. So I think it is very difficult for us to cast aside whole areas of responsibility and announce that we won't be doing them anymore because we don't have the funding when Congress has directed us to do them. But under the House budget proposal, there are a couple of areas I would focus on as particularly concerning.

Clearing house oversight is one of them. Clearing houses clear close to $2 trillion a day worth of transactions. There are nine clearing houses. We have 10 dedicated examiners to perform that function. We will not be able to operationalize the OTC derivatives rules. We will get the rules done, but we will not be able to operationalize them and that will result in a lack of oversight, and frankly uncertainties for an industry that has to operate under that regulatory regime.

I think that we will see the number and scope of our enforcement actions decline. We may decline to prosecute where the costs of investigating or litigating are just too high. We may name fewer respondents or defendants in our cases. Our exam coverage, which I think is already inadequate, will suffer. We have 700 examiners for 15,000 regulated entities.

One-third, as I said before, of investment advisers have never been examined. We will not have examination resources for hedge fund advisers when they come under our responsibility in the first quarter. We will have to cut IT spending clearly, which will be unfortunate because we need to modernize systems like EDGAR, which receives all corporate filings, is used by the public, by the staff, and by public companies, and is a critical system for the SEC. I think we will also be hindered in our ability to hire industry expertise.

We will essentially be in a hiring freeze in 2012 under the House number. And I think something that business cares very much about, as we do, is that our ability to quickly and efficiently review the increasing flow of IPOs could be hindered as well. And that is something I don't think any of us wants to see happen.

So across the agency, I think you would find there are real impacts on investor protection but also on capital formation and those processes that are critical right now.

Mrs. MALONEY. My time has expired. Thank you.

Mr. SCHWEIKERT. Thank you. Mr. Luetkemeyer.

Mr. LUETKEMEYER. Thank you, Mr. Chairman. Ms. Schapiro, very quickly, I am just curious to follow up on Mrs. Biggert's comments and questions with regard to DOL's fiduciary role. Have you been working with them in concert to try to resolve that situation?

Ms. SCHAPIRO. Our staffs have spent a lot of time talking, and from our perspective, trying to educate them about the securities laws and how investors are protected under the securities laws through either fiduciary duty or suitability requirements and about the panoply of regulatory requirements that exist to govern the relationship between an adviser or broker and their customer. But as I said, at the end of the day, we don't administer the ERISA law. The Department of Labor does, and it has to be their call about whether or not to propose rules under that statute.

Mr. LUETKEMEYER. Is it your assertion then that the ruling does not infringe on an area of fiduciary responsibility that falls under the SEC's oversight?

Ms. SCHAPIRO. Certainly, it will impact some regulated entities that the SEC also has responsibility for, who might be advising customers about their IRA accounts, for example, and are likely to also be registered as securities brokers.

Mr. LUETKEMEYER. You are not concerned about that?

Ms. SCHAPIRO. I know the industry is gravely concerned about it. And we have spent a lot of time talking with them about it. As I said, we have met with DOL. We have explained the issues to them. But it is their responsibility to do what they believe they need to do under ERISA, and we have no capability with respect to ERISA.

Mr. LUETKEMEYER. Yes. But don't you think that if they are getting into your territory, you should work with them to let them know that they have overstepped—they can't hide behind that authority or adopt rules here that are going to impact other things that they shouldn't have any ability to impact?

Ms. SCHAPIRO. I believe they do have the ability. And as I said, I think the most the SEC can do is really to help educate them about how the securities regulatory regime, we believe, protects investors in this context. But the people subject to SEC regulation, because they are broker-dealers, may also be subject to State insurance regulations or by the DOL under ERISA. They are—unfortunately, I think they would say—subject to multiple regulatory regimes. So I don't think we can say that just because we have a regulatory responsibility, that DOL is excluded from doing what they believe they need to do under ERISA.

Mr. LUETKEMEYER. My concern is that we certainly are going to limit the ability of individuals to be able to have the expertise to advise them on their securities. I had a meeting yesterday with an individual. He is the only gentleman in the entire county who has a securities license. And you continue to allow other entities to get into security advising situations. So I think it is going to dramatically continue to impact the ability of individuals to get expertise to be able to make the wise decisions. I am very concerned about this.

Ms. SCHAPIRO. I share that concern, Congressman. I will tell you, we are very sensitive as we look at what we might do in this area to be careful about being business model neutral to the extent we can, to understand that access to financial services is something that all citizens should have at a reasonable cost and in a reasonable way. We are very sensitive to those concerns as we think about what we might do here.

Mr. LUETKEMEYER. I would certainly urge you to be working with the DOL folks and Treasury to try to find a way to work to come up with some sort of a common ruling here on this. I am not against trying to make sure that the consumers are protected, but I think that the pendulum has swung a long way in the wrong direction on this issue, and I think we need to bring it back to where we have all of the agencies working together to find the best fit and the best common ground to allow some protection, yet allow the products to be sold by the individuals and so consumers can get what they need.

Very quickly, I have one more question for you. I am the sponsor of the Communities First Act, which is the independent community bankers bill, this year, and we are wanting to raise the threshold on shareholders on some small companies from 500 to 2,000. It hasn't been done, it hasn't been raised in years, and I would just kind of like your opinion or to see if you have any concerns. I know raising it that high suddenly, you don't have to have as many folks to regulate and examine, so maybe we are taking a little burden off your shoulders.

Ms. SCHAPIRO. This is a very important issue to us right now. You may have seen that we just announced the creation of a Small Business Advisory Committee. I believe a community banker serves on that committee. We have met a number of community bankers who have raised this issue about the 500 shareholder reporting threshold and the burdens it places on those in the community. And so we have a fairly robust review going on right now of a number of issues around small business capital formation. The 500 shareholder limit is well advanced in our deliberations, and we are also looking at a number of other issues like crowdfunding and the general solicitation ban, quiet periods and so forth. So we have a full menu, and we are very anxious to get our first advisery committee meeting called and the input of experts on the ground who can help us with these issues.

Mr. LUETKEMEYER. I am anxious to see your results. Thank you very much for your time today. Thank you, Mr. Chairman. I yield back.

Mr. SCHWEIKERT. Mr. Gutierrez?

Mr. GUTIERREZ. Thank you very much, Mr. Chairman. Chairman Schapiro, when we wrote, drafted the Dodd-Frank bill, and passed it in the House and the Senate, one of the things that we did was say there was going to be a study so we could kind of streamline and the improve Securities and Exchange Commission. And so, one of the bills we have before us today would kind of codify the recommendations made by the study group. Is that going to help you streamline and improve the efficiency of the Securities and Exchange Commission in your opinion?

Ms. SCHAPIRO. I think, Congressman, there are some things in the bill that are worth exploring. I will say my primary concern is that we not set a rigid structure for the agency in statute. This is an agency I think we could all say didn't evolve quickly enough and rapidly enough in response to changes in the markets and the world over the last several years, and we need the flexibility to organize the SEC on an ongoing basis over time to be responsive to tremendous developments in the marketplace. So that would be my primary concern with the bill.

There are some other issues with which I would also disagree, but we are more than willing to try to work with the committee to see if there is some legislative approach that does make sense.

That aside, though, you should understand we are very committed to reforming the SEC. I came to an agency pretty badly broken in many regards, and we have undertaken tremendous reforms already. We know we have a long way to go. We are open-minded and trying to be thoughtful and careful about how we do that, but also to proceed with some sense of urgency. But I worry about it being locked into statute and in 5 years discovering that the model doesn't work and we need an act of Congress to put the agency back together.

Mr. GUTIERREZ. Let me then follow up with the following: my friend from New Jersey, Mr. Garrett, has a bill that would require cost-benefit analysis before you could, the way I understand it, proceed.

Tell me how you see the bill and cost-benefit analysis, and does that give you the kind of flexibility and quickness that you might need in order to respond to what you suggest are changing markets and maybe failures in the past that you have come to attempt to address?

Ms. SCHAPIRO. Sure. And let me say at the outset, I support good standards that are clear. But they have to be achievable for us, and they have to be consistent with our mission, and I really feel that the way this bill is structured, almost no agency of government could meet all of these standards and all of these requirements as they are laid out.

We already do cost-benefit analysis. We look at effects on competition of our rulemaking. We consider the impacts on small business. We test and estimate the paperwork burden of our information collection. We look at whether our rulemaking will promote efficiency, competition, and capital formation. So we do extensive cost-benefit analysis, and we know we can do it better, and we are committed to doing it better. But this bill adds so many new provisions, 11 new factors that the agency is—

Mr. GUTIERREZ. Eleven new factors that have to be considered before you can do what?

Ms. SCHAPIRO. Before proposing not just regulations but also orders which emanate from enforcement cases and exemptive orders, and orders even approving self-regulatory rules. So it is an extraordinarily different standard than applies anywhere else in government, and it is I think almost impossible to meet.

Mr. GUTIERREZ. I thank you for those answers because it seems to me that we have a Congress and a Majority, Members on the other side of the aisle who are always speaking about new requirements and new standards that they believe inhibit the ability of the small business person and business in general to succeed and to thrive, and that they advocate for smaller, less government and fewer regulations.

I find it curious that when it comes to the agency whose major purpose is the Securities and Exchange Commission to watch, they want more regulations and they want to hamper it, and they want to tie it up in knots. I don't quite understand how it comes to government in general when it is vis-a-vis the business community. And then when we have a group that is supposed to monitor part of that business community, investment business community, we would even want more regulations. And I would suggest that in a society in which something as simple as a credit card for 25,000 miles, I did get the credit card, I got the 25,000 miles, the only frequent flyer mile ticket I could get was from Chicago to Milwaukee, a 90-minute drive. Apart from that, I didn't get any other benefit.

I say that part in jest, but in part because I said if those are the consequences to me, imagine the other kinds of things consumers are subjected to and that we need to monitor.

Thank you for your time today and your commitment.

Mr. SCHWEIKERT. Thank you, Mr. Gutierrez, although I think Milwaukee feels a little disparaged right now. Chairman Garrett?

Mr. GARRETT. And I thank the Chair. So I guess I am in the position of actually being the Republican here defending more regulation, and that is what my bill would essentially do.

Let me just begin by reading something from the previous Executive Order: "The American people deserve a regulatory system that works for them, not against them, regulatory policies that recognize that the private sector and the private markets are the best engines for economic growth." That is not from this Administration. That actually goes all the way back to 1993 from the Clinton Administration, trying to do what we are trying to do now effectively with—through their Executive Order, with a piece of legislation that we are discussing here.

I know a couple of issues came up through the ranking member, one of which pertains to our legislation dealing with the issue of applying to orders, right? So since this is a discussion draft, this is the reason why we are going through regular order here, this is something that wasn't done in the past term, but we would like to go through regular order, an opportunity to hear if there are problems with the legislation and whether they can be fixed. So that is one that we are more happy to discuss whether it can be fine-tuned with regard to orders.

The second point I guess that was raised was the issue with regard to putting the cart before the horse or not, where we say that you have to identify the problem first that you are going to potentially address through a regulation. I guess there was some comment by the ranking members or others saying, that seems to be the reverse order.

Again, let me go back to the Executive Order of Bill Clinton that says that was his intention, that you have to identify a problem before you actually start doing the whole regulatory process. He said each agency shall identify the problem that it intends to address, including where applicable, so on and so forth, as well as assess the significance of that problem. And I think that only makes sense, that you begin doing it in that manner.

Now, I appreciate the fact that you did say that you already do cost assessment analysis, but as you heard in my opening comments, the D.C. Circuit Court of Appeals begs to differ with the nature and the quality of the rulemaking. So I guess my initial question is, what is your reaction to that and what steps are you going to take in reaction to the Court of Appeals' decision with regard to the proxy assess rule, not so much on the proxy assess rule per se but on the process?

Ms. SCHAPIRO. Sure. Obviously, we are disappointed by the court's decision—they vacated the rule—because we thought it was important that it be possible for long-term shareholders with a significant economic stake in a company to be able to have their nominee for director considered by other shareholders. Nonetheless, we take very seriously our obligation to consider the costs and benefits and the economic impact of the rules we adopt. And I believe if you were to look at the SEC's rules compared to many other financial regulatory agencies, you would see that we do a much more extensive cost-benefit analysis than others do. That said, though—

Mr. GARRETT. Maybe I will just digress there, and I don't mean this flippantly at all. It may sound that way when I say this. If you have information on other agencies that you would—I would be more than happy to take a look at them as well. I know it sounds that way, but we should be making sure that everyone—you agree on the same level and the same thoroughness.

Ms. SCHAPIRO. I do think it is important that everybody do robust cost-benefit analysis. All of that said—and I think our staff has done a very good job on many rules—I have asked the staff to reevaluate the whole process for conducting the analysis, not just the process of the economic analysis, but the substance of it, assuring that we better integrate, for example, our economic analysis throughout the course of the rulemaking process. We are expanding our Risk FIN Division in stature and size so we have more economic firepower. We are taking more care with our rules to explain the choices that we make.

Mr. GARRETT. Let me just stop you there, too; because as far as one of your other comments, you said our legislation would mandate you to consider more factors in the process. I think you said 11 different factors. Actually, our legislation says not that you "shall" but that you "may" consider those factors. We are just saying these are things that Congress believes should be considered.

Ms. SCHAPIRO. That is right; they are not mandatory.

Mr. GARRETT. Right.

Ms. SCHAPIRO. But because they are contained in statute, they are highly likely to be used in a challenge against the agency of the next rule that doesn't make a mandatory evaluation of each of the factors. And finally, we want to explain more clearly, learning from the proxy access decision, how we make the choices we make and how we consider the differing views that come in through the comment process and through other means.

Mr. GARRETT. My time is really just up, but can you get back to us? We just had a hearing on the separate issue of investment advisers, that issue and the study that came out of that. I know you have worn two hats in your life, both here and over in your previous position, as to the cost basis, for the cost of doing these examinations. And I would just be curious; we know the disparity with regard to the examinations between investment advisers and broker-dealers. I would just be curious if you have numbers, an explanation as to not just the numbers of examinations that are done but the actual—the nature of the examinations on both, and also the cost.

Ms. SCHAPIRO. I am sure we could do—it won't be scientifically precise, but I am sure we could do ballpark figures for broker-dealer examinations versus investment adviser examinations.

Mr. GARRETT. Great. And I yield back. Thank you.

Mr. SCHWEIKERT. Thank you, Chairman Garrett. Mr. Sherman.

Mr. SHERMAN. Thank you. I want to focus on credit rating agencies. Dodd-Frank had a couple of provisions. One involved moving around the organizational boxes, and I regard that as pretty inconsequential, like moving around the deck chairs on the Titanic. And then the Boston Consulting Group makes that part of the bill or recommends that part of the bill may be made even less consequential in that you are not even going to change the boxes, you are just going to have the two existing boxes talk to each other, which makes it even less consequential. But since it started off as inconsequential, that is not my focus here.

My concern is that due to the work of Senator Franken and myself, there is a very consequential provision, and that is a provision that requires the SEC to create a system to assign the credit rating agencies rather than the current system in which the home team selects the umpire, and whoever is selected gets a million bucks or two million bucks or whatever their fee is. I have used the analogy what it would be if the home team selects the umpire. We are used to softball leagues where the umpire gets some beer, and so might not bend over backwards to get the chance to umpire again. These umpires get paid a million bucks or more.

Is the fact that there is nothing here in this report about the SEC organizing to undertake this new function, is that in some way prejudicial to undertaking the function? Or is this report simply irrelevant to Senator Franken's work and my work?

Ms. SCHAPIRO. I would like to have my colleagues address that as well, but let me just say that we think it is a tremendously consequential part of Dodd-Frank.

Mr. SHERMAN. Are you referring to the—

Ms. SCHAPIRO. No, not the boxes. I am referring to the study of whether there is a better, less conflicted business model that might be explored for credit rating agencies. We have out for comment right now and are receiving comments on a series of questions about different ways to structure how we might do that and to get information in so the staff can go ahead and proceed with that study.

As you know, it was not one of the 1-year deadline items under Dodd-Frank, so it took its place in queue a little bit behind other things.

With respect to the credit rating agency office, let me just say that the work of the office is ongoing, even if the structuring of it has not been changed, to have it report directly to—

Mr. SHERMAN. If I can reclaim my time. My concern with your answer seems to be that the SEC's sole obligation is to just do this study and that you are free to reenshrine the status quo. I think you are obligated by the statute to radically change this giant conflict of interest, and I hope you are structured in order to accomplish that goal.

Ms. SCHAPIRO. As I recall, and I haven't looked at this provision in a while, we are required to either implement the proposal that is in the statute or come up with another proposal. The study is a prelude to our being able to do that in an informed way.

We are also doing, as the statute required, an annual exam of every nationally recognized statistical rating organization, and we have created the Office of Credit Rating Agencies. It is just not reporting directly to the chairman, as the statute would require, at this point, because we don't have reprogramming authority to do that.

Mr. SHERMAN. Who reports to whom, I leave to you and the Boston Consulting Group. And I am glad to establish that at least these charts here don't mean that you are not ready to implement the results of that study.

But maybe the Boston Consulting Group can comment. Did your proposal for how to organize the SEC envision that the SEC would be selecting the credit rating agency for each debt issuer, or is this the organization chart for an SEC that doesn't undertake that responsibility?

Mr. SAUMYA. Congressman, the issue that you just raised was not part of the scope of our work, so we did not look at that. This was simply to look at the proposal that had been made to create the credit rating office, to look at overseeing credit rating agencies, and that are existing functions at the agency today. We recognize the importance of this, and we were laying out options on how best they could be organized.

Mr. SHERMAN. I misunderstand your answer here. You seem to be saying your report ignored the possibility, or I think the mandate, that the SEC undertake this new responsibility and was focused only on how to organize to meet its current responsibilities? You are shaking your head. Does your report lay out a program for organizing the SEC that would be selecting the credit rating agencies for debt issuers?

Mr. SAUMYA. Our report assumes that the agency will follow what is required under the legislation. This was simply an organizational design issue that we focused on.

Mr. SHERMAN. Okay. Given the fact that the Chairwoman has indicated that it may be—my reading of your report is that you simply ignored that the SEC would undertake that function.

Ms. SCHAPIRO. Congressman, if I could just add, at the time when the study is completed and the SEC determines what the right structure is, whether the SEC will select a credit rating agency, whether a self-regulatory organization might do it, whatever we determine to be the optimal new business model, then we will, of course, have to restructure the SEC to accommodate that.

Mr. SHERMAN. Okay.

Ms. SCHAPIRO. So that we are doing it—

Mr. SHERMAN. Hopefully, the fee you have paid to Boston Consulting Group will cover any additional work necessary at that time. And I yield back.

Mr. SCHWEIKERT. Thank you, Mr. Sherman. Two quick things. Chairman Garrett has a motion, and then we will move to Mr. Posey.

Mr. GARRETT. Right. I ask unanimous consent to enter into the record a letter to the Commission with regard to beneficial ownership reporting rules and how they may or may not be changing and the revisions for the record.

Mr. SCHWEIKERT. Unanimous consent? So ordered. Why not?

Mr. Posey, it is your turn.

Mr. POSEY. Thank you very much, Mr. Chairman. Madam Chairman, a colleague came up to me and said the SEC is fracking crazy, and I thought they needed a vocabulary lesson, and then I read the Wall Street Journal article that now the SEC is determining that it is going to regulate fracking in the mining industry. And I wondered, with all the victims, potential victims, citizens who are at risk for securities abuse, why in the world the agency feels it is necessary to go into the environmental business now, further into the environmental business than before, when there is so much work yet to be done. And the agency was whining about not having enough money in the budget now to focus on securities per se, and now wants to involve itself in what appears to most to be a responsibility of an environmental agency, of which we have plenty.

Ms. SCHAPIRO. Congressman, that is a very fair question. We are not in the business of regulating fracking, and there were a number of newspaper articles, you might recall, a while ago that suggested when the SEC changed its rules for public companies to report their oil and gas reserves that, as a result of those rules being liberalized by the SEC to allow for reporting of potential reserves as opposed to only proven reserves, that companies were then exaggerating what their oil and gas reserves were in their public disclosure documents that investors rely upon to buy and sell stocks.

I believe our review group for that industry in our Corporation Finance Division has asked questions in their comment letters as they send them back and forth to companies about their methodologies for estimating their reserves and putting that in their disclosure documents.

I would be happy to get more information for you about it, but I want to assure you we are not regulating fracking in any way, but we do have responsibility to ensure honest and fair disclosure about issues like reserves.

Mr. POSEY. Generally, I have been able to pretty much trust the Wall Street Journal. I don't always agree with them, but generally, I trust what they write; they have good editorial and news safeguards. I am delighted to know that. If, when you get back to the office, anyone tells you differently or there is any light shed on it, I would appreciate you letting me know, because I am going to take your comments as the absolute gospel, and I am going to engage anyone who indicates that you are doing anything other than just verifying reserves.

Ms. SCHAPIRO. Let me be clear. I don't know that we are not asking more questions than just the verification of reserves. There may be other issues in the comment letter. So let me come back to you with as complete an answer as possible. But what I was trying to make clear is that we are not telling people they can or cannot engage in fracking or any of those kinds of issues, but we do ask questions to try to get a more complete disclosure about the risks, about reserves proven or estimated, and so forth, but let me come back to you with a more complete answer.

Mr. POSEY. The space between not regulating fracking and merely making sure the disclosure requirements are correct on their reserves is big enough to drive a million space shuttles through, so I think that would be important, and I hope that you would maybe respond to me and the chairman, with his permission, and anyone else who has an interest in here.

Ms. SCHAPIRO. Absolutely.

Mr. POSEY. In writing within the next week.

Ms. SCHAPIRO. I would be happy to do that.

Mr. POSEY. Thank you.

Mr. SCHWEIKERT. Mr. Posey, anything else? Thank you, Mr. Posey. Mr. Carney?

Mr. CARNEY. Thank you, Mr. Chairman, and I thank the panel for coming today. I would like to just expound a little bit on the two parts of the discussion that we have had today, this issue of cost-benefit analysis. We have heard what Mr. Garrett's view of that is, and he has legislation that would require these kind of assessments to be done. And we heard earlier my colleague, Mr. Himes, and his caution about how to do that with respect to tail effects and so on.

So first to the BCG folks, how would you do that to accommodate the concerns that Mr. Himes articulated?

Mr. SAUMYA. Congressman, this issue was outside the scope of our study. Our study focused on—

Mr. CARNEY. I am not asking you really—and if you don't want to offer an opinion—you do cost-benefit analyses for clients, don't you?

Mr. SAUMYA. Yes.

Mr. CARNEY. How would you envision accommodating some of the concerns that Mr. Himes had about how you get low probability effects that have cataclysmic impacts on the financial system in this instance? Do you have any thoughts on that?

Mr. SAUMYA. We will have to reflect on that and get back to you.

Mr. CARNEY. Okay, thank you.

Ms. Schapiro, do you have any view on that? If Mr. Garrett's bill were to pass, how would you implement that? How are you doing it now that accommodates the concerns that were articulated by Mr. Himes, which I think are real concerns? If you look at the financial crises that we have had historically, they have been created by some of these things that are not expected.

Ms. SCHAPIRO. I think it is a very difficult question. The costs are almost always easier to quantify than the benefits are, and we struggle with that; and we try, if we can't actually quantify benefits, to at least discuss as fully as we can what we believe the benefits would be and balance from there.

Mr. CARNEY. But that is an important part. That is an essential part of doing an analysis like that.

Ms. SCHAPIRO. It is essential.

Mr. CARNEY. You have to enumerate costs and benefits and what they are and assign values to them. And as Mr. Perlmutter and Mr. Himes pointed out, sometimes that is difficult to do.

Ms. SCHAPIRO. And failure to act has a cost as well that we often don't quantify, either.

Mr. CARNEY. Right.

Ms. SCHAPIRO. I think cost-benefit analyses would be more useful if we did talk sometimes about if we don't act, what are the potential ramifications of that if other events come to pass.

Mr. CARNEY. So do you have a view as to how you might implement something like this in a way that would result in what is in the legislation a "reasoned determination that the benefits justify the costs?"

Ms. SCHAPIRO. I think what we do now is, while we haven't done it perfectly in the proxy access case, and historically in a handful of other rules, I think what we do now is really geared towards getting a reasoned judgment about whether a rule's benefits will outweigh its costs. And my fear about this legislation is that it layers so many analyses on top of what we already do that we are set up to fail; that there is no way that this agency or any other agency can possibly do all of these things, some of which conflict, some of which seek to protect market participants. Sometimes we need to protect market investors from market participants.

I think there are—we would be happy to work through these issues in this legislation as constructively as possible, but I think there are a lot of things here that make it very difficult for us to—

Mr. CARNEY. I think in concept Mr. Garrett's idea makes sense, but I think implementing it is difficult to do, particularly to accommodate the concerns that Mr. Himes has.

I only have a minute to go, and there has been a lot of discussion about priorities. You mentioned earlier some of the things that you don't think are getting the priority that they ought to. Could you go over those again? And I agree that we ought to have a discussion about what those priorities are so that you know what Congress believes the priorities ought to be and that you have—you can challenge us or tell us what you think they ought to be, and we can have a reasoned discussion of that. In 30 seconds, could you—

Ms. SCHAPIRO. I would be happy to, and let me add to the ones I said before.

Mr. CARNEY. I missed one of them. You had clearing house oversight, hedge fund adviser examiners, hindering of hiring expertise, and there was one other that you mentioned that I didn't—

Ms. SCHAPIRO. Building the necessary information technology infrastructure to be more efficient, operationalizing the OTC derivatives rules. And I would add to that our ability to ensure that we have a stable equity market structure in this country so that public companies can cheaply and efficiently and transparently have their stocks traded, and investors can feel like they are participating in a market that operates fairly for them. We have spent a lot of time on market structure, but it is an area where we have to have data and tools in order to really do a good job, and those cost money.

Mr. CARNEY. Thank you very much. I see my time has expired. I do believe that we ought to extend this conversation for sometime in the future to go over these priorities and how to implement some of the things that you are trying to implement.

Mr. SCHWEIKERT. Thank you, Mr. Carney. Mr. Pearce?

Mr. PEARCE. Thank you, Mr. Chairman. I would join my colleague Mr. Carney in saying that this conversation should be a little bit longer, so if we get the chance to visit with Ms. Schapiro again, that would be good.

I would like to add my voice, Ms. Schapiro, to that of Mr. Posey, on the fracking. The Wall Street Journal actually says you are asking questions about the chemicals used, which somewhat deviates from the idea that we are trying to prove reserves.

I see in your report, page 10, page 11, twice on page 11, resources constrained, environment resources constrained, resources do not permit, and yet you are drifting off into these environmental questions; and I wonder, are you asking the same questions of, say, the manufacturers of windmills? Those electric generating windmills are scattered across New Mexico; they kill birds, they affect the environment. Are you asking about that same sort of environmental impact on those companies?

Ms. SCHAPIRO. Congressman, I would like to get back to you with more detail. Our goal is not to vindicate any kind of environmental interest here.

Mr. PEARCE. It appears that you have, with all due respect, and I would appreciate it if you would get back with me.

On page 2, you are describing the payouts, $2.2 billion, $2.8 billion. How much of that came from Mr. Madoff's settlement?

Ms. SCHAPIRO. I don't believe any of that. That has all gone through the SIPC process.

Mr. PEARCE. Has any investor been compensated anything from your efforts, from the efforts of the SEC?

Ms. SCHAPIRO. I would have to get back to you on whether any fines or penalties went into the SIPC fund from the SEC. I don't know the answer to that.

Mr. PEARCE. You mean we have the most highly visible investor defrauding that has ever occurred, and you don't know the answer to that?

Ms. SCHAPIRO. Congressman, because our goal would be not to take money into the Treasury and deprive the—

Mr. PEARCE. I asked if any payments have been made back to investors.

Ms. SCHAPIRO. I am sorry; I just don't know the answer to that.

Mr. PEARCE. Do you understand from my point of view how astounding that is, that the most highly visible—you are in charge of this, you are the one, and—

Back in 2008, Evergreen Silver, ESLRD, a NASDAQ company, filed for—they had assets of a billion dollars. They make silver sales, they are publicly traded—they were—and they filed bankruptcy. They took $58 million of Massachusetts money with them. Do you have that on your radar scope?

Ms. SCHAPIRO. I am not familiar with it. I would have to get back to you.

Mr. PEARCE. SpectraWatt Incorporated spun off of Intel, they took money from Goldman Sachs, who you do have; SpectraWatt was a private firm, but they took large sums of money from Goldman Sachs. They also took public money from New York State. And I wonder, after they filed bankruptcy, did you have any insights on them?

Ms. SCHAPIRO. Again, Congressman, I don't—we have thousands of investigations ongoing at any one time. I would be happy to try to find information for you.

Mr. PEARCE. But your agency does have time to go in and worry about fracking?

Ms. SCHAPIRO. I am not suggesting that we do or don't have investigations of those particular companies. I just don't know.

Mr. PEARCE. I am saying that you do have the money to put a front page article in the Wall Street Journal that you are investigating fracking and the chemicals used there. I am saying that sometime you should take care of your business instead of the EPA's business.

Ms. SCHAPIRO. I understand.

Mr. PEARCE. A very highly visible firm just in the last day or two, Solyndra, came under your jurisdiction when they filed to incorporate and filed for a public offering. Given the events of the last 2 or 3 days, have you done anything to look at Solyndra and what you might have warned the American taxpayers about before we gave them $400 million or $500 million?

Ms. SCHAPIRO. I can't comment on any ongoing inquiries that the agency has.

Mr. PEARCE. You can comment if you do or don't have an investigation. Do you have an investigation? Are you looking at that?

Ms. SCHAPIRO. Actually, I can't comment on whether or not we have an investigation.

Mr. PEARCE. Okay. We have begun to get information from the small investment advisers that they are facing standards that maybe the big guys don't face. Again, I would like at some point to hear your observations—we don't have time today, but I would like to hear your observations on why you would be concentrating more efforts on the small fish than the Madoff fish.

I just worry that what we are going to do is implement regulations on the mom-and-pop operations across the country who had nothing to do with any of the investment problems that we have seen in a big way off of Wall Street. And I do hope that as you are implementing your regulations, you will be considerate of where the big fish are to fry.

I yield back, Mr. Chairman. Thank you.

Mr. SCHWEIKERT. Thank you, Mr. Pearce. Mr. Perlmutter?

Mr. PERLMUTTER. Thanks. And I wasn't going to get this, but I want to respond to my friend from New Mexico. Chairman Schapiro, you are familiar with a company called the Reserve Fund, are you not?

Ms. SCHAPIRO. Yes.

Mr. PERLMUTTER. The Reserve Fund, I would say to my friend from New Mexico, probably cost State governments and special districts zillions potentially, because it broke the buck, and all these guys invested in it. The SEC was all over it and helped recover—and my guess is New Mexico's special districts and local governments had a lot of money in that, as well as Colorado—but helped them recover on average, I think, about 95 or 98 or 99 cents on the dollar. So that was a big one. It affected each State, and they were all over it. So, I don't know the specifics of all the little questions you were just asking, but certainly in defense, I want to say that.

Now, let's get to the guts of this thing. I appreciate the gentleman from Boston Consulting and your study. The question is: Should there be more private, in effect, assistance and enforcement and oversight with an umbrella kind of potentially being—what we are saying is there is not enough money to do all the jobs that are assigned to the SEC at this point. There may be other ways to do it, using FINRA or some other organizations.

Here is my question—or it may be coming from the legislation. I am looking at an article today in the Denver Post about outsourcing of government jobs, where it says, for example, a study found that on average the Federal Government paid contractors $268,653 per year for computing engineering services while government workers in the same occupation made $136,456. Human resources, the annual rate was $228,488 for contractors, more than twice the $111,000 for the same services done inhouse.

I have no problem with the private sector making a lot of money. We had Mr. Ketchum in here from FINRA a couple of days ago and he said, "I want to be fully accountable to the Congress." I am not sure if he really means all of that because the salaries at FINRA are pretty substantial. But whoever it is, whether it is the public organization, the SEC, or assigning it to somebody else to help, there is responsibility. And I mentioned the math earlier about how a 6,000 drop in the stock market translates to $7.8 trillion, which is a lot of money. That is a huge user fee for a lot of people.

So explain to me, if you would, either Ms. Schapiro or the others, there is responsibility with or without Dodd-Frank. Can the agency do it on the budget that it has today?

Ms. SCHAPIRO. I will be happy to start. I think I have been pretty consistent with Appropriations and in testimony generally over the past year, that we cannot operationalize the Dodd-Frank rules without additional resources. We agree with the BCG report that we have the opportunity to optimize the use of our resources. We are looking for savings wherever we can find them. We have some opportunities to do things differently that we think will free up some resources. But at the end of the day, we are taking a piece of the $600 trillion over-the-counter derivatives markets under our responsibility—hedge fund regulation, credit rating agencies, municipal advisers, large new areas of responsibility that the Congress, and frankly the American people, will expect us to do well; and without significant additional resources, that is simply not going to happen.

Even if we become very efficient, very effective, very agile, all things we are working towards, at the end of the day, there is a gap.

Mr. PERLMUTTER. Let me ask the gentleman from Boston Consulting, in preparing this report, I don't know whether we asked you to look at it, but do you consider the catastrophic losses? We are talking harm-benefit analysis, and I do think we asked for that in our study, but maybe not. Did you consider the catastrophic losses we saw in the fall of 2008 when I think the SEC hadn't been doing their job?

Mr. SAUMYA. Our focus, Congressman, was on looking at the organization structure, people, technology, and how they interact with the SROs. We took the SEC as we found it when we arrived and then looked ahead as to what capabilities they need to have to deliver against their mandate and mission, and so our focus was forward looking.

Mr. PERLMUTTER. Okay, thank you.

Mr. SCHWEIKERT. Thank you, Mr. Perlmutter. Dr. Hayworth?

Dr. HAYWORTH. Thank you, Mr. Chairman.

Chairman Schapiro, I know that the SEC is forming an advisery committee on small and emerging companies, and I think that is an important step in the direction of facilitating enterprise. We want our small businesses to be able to acquire capital, we want investors to be able to engage in that marketplace ever more fully.

One of the questions that proceeds or one of the challenges that proceeds from that beneficial action is that we do need a market for those stocks once they are issued. And as you know, right now we really lack that kind of a marketplace in the United States for various reasons. But a marketplace certainly helps investors to observe and to set a market value for these sorts of investments.

So would you be willing to work—my office is taking a particular interest in trying to facilitate a United States-based marketplace analogous to France's Alternext or London's AAM. Could we work with you to see what we can do to facilitate setting up that kind of a market?

Ms. SCHAPIRO. Absolutely. We would be happy to do that. You should know it is just getting started. NASDAQ has created a venture marketplace from the roots of the Boston Stock Exchange that they bought. And while I don't think it is fully up and running yet, the Commission did approve that. It was one of our efforts to try to create a better, more transparent trading market for lower-priced securities. But we would be happy to work with you.

Dr. HAYWORTH. Great, I appreciate that. And we are eager to work with you, so our staff will get in touch with yours, and we will continue to move forward on that. I appreciate it.

I do have another question regarding revisiting the Williams Act and Regulation 13(d). And, in specific, the SEC is looking to respond to a lawsuit by Wachtell that is requesting that the timeframe for disclosure be reduced substantially from 10 days to 1 day. That could have, as you can imagine, a substantial effect on that sort of investor engagement, and many unintended consequences potentially because, of course, the Williams Act comprises a number of spheres of activity, so intervening in one place may indeed create an imbalance. So it does strike me that the division of risks, strategy, and financial innovation should be involved, and study the potential effects of these proposals. Are you planning on asking them to explore all the implications and the cost-benefit of this kind of an intervention?

Ms. SCHAPIRO. Absolutely. This is, as you intimated, a very controversial proposal. The staff has not made any recommendations at all to the Commission about it, but they will be very involved.

Dr. HAYWORTH. Great. I appreciate that, because clearly we are functioning in an environment in which everybody is exceedingly concerned about our being a destination for working capital in this country, and I know that you are dedicated to doing the right thing in that regard. So I appreciate hearing that. I think that is a great, thoughtful approach.

Thank you, and I yield back, Mr. Chairman.

Mr. SCHWEIKERT. Thank you, Doctor. Mr. Hurt?

Mr. HURT. Thank you, Mr. Chairman. I want to thank the chairman and all of the witnesses today for your being here. I am Robert Hurt from Virginia, and one of the things that concerns us the most in my rural southern Virginia district, of course, is jobs. I think it is on the top of everybody's mind. I was pleased that the President last week tipped his hat to capital formation as something that is very important to help get this economy going.

One of the bills that has been passed out of this committee is a bill that would extend the same exemption to private equity that has been given to venture capital and would repeal that part of Dodd-Frank dealing with that issue. That is obviously, in my opinion, a Main Street issue. I know of thousands of jobs, hundreds if not thousands of jobs that are in Virginia's Fifth District as well as across the Commonwealth and across this country that have been created by the capital formation that is provided by private equity.

I was wondering, Chairman Schapiro, if you could articulate for me any possible benefits? What are the benefits to requiring advisers to private equity to register with the SEC, and what could possibly be the benefits of the quarterly and sometimes monthly evaluation reports? What could SEC, with the strapped resources that you have, do to improve what private equity has done for the economy, especially at a time when our economy is failing, and private equity I think has proved again and again to be able to create jobs at a time when we are losing jobs?

So in the context of cost-benefit, let's talk about the benefits first, and then we can talk about the costs. But what possible benefits can you see?

Ms. SCHAPIRO. Congressman, I think I am familiar with the bill that has been reported out that would basically exempt private equity levered less than 2 to 1.

Mr. HURT. Correct.

Ms. SCHAPIRO. Which I think is an interesting approach. With respect to private equity, when the Commission followed the requirements of Dodd-Frank, which during the course of the debate, considered actually exempting private equity along with venture capital, and ultimately the decision was not to. Our obligations there are with respect to reporting and registration only. There are not sort of substantive SEC requirements on that, and it is part of understanding the broad scope of participants in the financial services industry and in the economy who have the potential to impact other financial institutions and investors in a fundamental way.

Mr. HURT. And I guess the reason I ask is because—for a couple of reasons. I think most people agree and I think the view of this committee, a majority of this committee, was that private equity is different. It is not leveraged at the fund level. You have, of course, highly sophisticated investors, and then of course the portfolios by design are necessarily diversified, so there is no financial or no financial systemic risk, I think, to be concerned with.

Let's talk about the costs because I am interested—and I appreciate the fact that you brought up the "cost-benefit analysis," that phrase. Obviously the costs are, in my opinion, very significant. We had one witness who testified that it would cost their company almost a million dollars to register, and then an ongoing cost, of course, of hundreds of thousands of dollars to continue to file these reports. And my view, my Main Street view, southern Virginia view, is that is money that could be used to invest in another Dollar General or in another Ply Gem window manufacturer in the Fifth District. That creates jobs.

So I am wondering, do you believe that what I would call unnecessary reporting and registration would negatively affect those private equity firms that would have to then comply with this?

Ms. SCHAPIRO. I guess I would have to go back and look at the analysis that was done when the rulemaking was promulgated to perhaps answer that more completely, and I am happy to do that. I do know that we met with a number of middle-market PE firms in the course of this, and one of the things they did ask for was a delay in their registration of a year, I believe; and so I think we have done a 9-month delay at this point.

Mr. HURT. Yes, you have.

Ms. SCHAPIRO. So we have some opportunities to continue to talk, and I would be happy to come up and have further conversations.

Mr. HURT. Thank you. And I wonder, following along these lines, it would appear to me that under the Investment Adviser Act, you all have the authority to exempt; and is that something that you would consider?

Ms. SCHAPIRO. We do. We were very conscious of the fact that the Congress made an explicit choice here. Sometimes things just don't happen, but here there seemed to be an explicit choice to require registration, which seems contrary to exercising exemptive authority, but again that is something we could talk about.

Mr. HURT. Okay. Thank you very much.

Ms. SCHAPIRO. Thank you.

Mr. HURT. I yield back.

Mr. SCHWEIKERT. Thank you, Mr. Hurt. I know there is a vote that has been called, but I was hoping I could throw out a couple of questions, and then you get to abandon us. But speaking both for the chairman and everyone here, we really appreciate your time.

Chairman Schapiro, you were kind enough earlier to mention the 500 shareholder rule, and I know the SEC has been looking at that for a while. I am also working on legislation in that subject area. What do you know about your rulemaking or your discussions internally? And if you have warm and fuzzy things to say about my legislation, we can talk about that.

Ms. SCHAPIRO. But only if I have—

Mr. SCHWEIKERT. Only if they are warm and fuzzy.

Ms. SCHAPIRO. I am actually familiar with—I think you have two pieces of legislation in this arena, one with respect to the Reg A offering threshold?

Mr. SCHWEIKERT. Yes.

Ms. SCHAPIRO. And that would require us to raise it, I guess, to $50 million, and then to consider in the future whether there are additional changes that ought to be made. And then secondly, the 500 shareholder limit and whether accredited investors ought to be excluded or the number of investors ought to be raised, or even employees could be excluded from the threshold.

Mr. SCHWEIKERT. Yes, employees.

Ms. SCHAPIRO. Those are all exactly the issues that the staff is looking at right now, and I would say that I think the 500 shareholder limit is probably the first item on the agenda that we hope to bring to the small business advisery committee to get their thoughts and perspectives on, and on the burdens of reporting, and whether there are any other alternatives. But we are moving very—"forcefully" may be a little too strong of a word, but we are moving very deliberately forward to do the analysis that we need to do.

When the 500 shareholder limit was put in place originally, there had been years of study, and it was carefully calibrated, and I think we don't want to just toss it out the window. We want to do an analysis, a cost-benefit analysis as well, but we are very committed to moving ahead on looking at this.

Mr. SCHWEIKERT. And I appreciate that. Actually this is one of those moments where the Republican side, you have been very kind, or your staff has been kind working with our staff, particularly in the Reg A issue. And in regards to the 500, in many ways that environment is more about capital formation, particularly for small, upcoming businesses.

Ms. SCHAPIRO. Right.

Mr. SCHWEIKERT. So in some ways, it is less about sort of modeling the cost; it is more modeling access to capital.

Ms. SCHAPIRO. Right.

Mr. SCHWEIKERT. I had just sort of an offshoot, and you are going to have to help me a little bit on this one, municipal advisers. I hear a lot from my banking community saying, we are regulated by everyone. And there is this sort of sense of concern saying, are they about now just to get another layer, particularly when they are doing some of the advising practice within those banks?

Ms. SCHAPIRO. When we proposed the municipal adviser definition, my personal view is that we cast a bit too wide a net, and we brought into that definition otherwise regulated persons who probably ought not to be included at the end of the day. The staff has not made a final recommendation. I understand the term sheet will be coming to the Commission very soon. We have gotten, I want to say, 11,000 comment letters. That might be another rulemaking. We have gotten thousands of comment letters.

Mr. SCHWEIKERT. In that case, have you heard from the other 11,000?

Ms. SCHAPIRO. I think we have heard from almost every Member of Congress as well. So we understand the issue. We cast a very wide net, perhaps inappropriately wide, and we are working through those issues.

Mr. SCHWEIKERT. I appreciate the wide net comment. It is one of those—we appreciate the struggle for resources in this particular environment. I am a fan of something Chairman Bachus is doing in trying to move forward with what was almost another 100 million in IT and technology money, believing that your access to technology, as has been stated here, would be sort of a one-time expense, but would actually make your ability to do your job much easier, but for all of us to see what is being done in your job easier, but—and I had this great fear of taking on something that would actually in the banking sector be huge and almost untenable in the current budget situation, so—and I think with that, if there is any burning comment left—if not, thank you for spending time with us.

Ms. SCHAPIRO. Thank you.

Mr. SCHWEIKERT. Thank you. We are in recess until the sound of the gavel, and I think at that point we will be moving to the second panel.

[recess]

Chairman BACHUS. The Financial Services Committee will come to order for the purpose of hearing testimony from our esteemed second panel. First, we will hear from the Honorable Paul Atkins, visiting scholar of the American Enterprise Institute, and former Commissioner of the U.S. Securities and Exchange Commission. Paul, it is great to have you back. You are a good friend and I look forward to your testimony.

Second, we will hear from Mr. Stephen J. Crimmins, partner at K&L Gates, and former Deputy Chief Litigation Counsel for the Division of Enforcement at the SEC.

Mr. CRIMMINS. Thank you, Mr. Chairman.

Chairman BACHUS. I am glad to have you here. I have read all of your testimony and I believe all of it is of value as we try to determine with the SEC what the best approach and a collaborative effort will be.

Third, Mr. Jonathan G. "Jack" Katz, former Secretary, U.S. Securities and Exchange Commission, on behalf of the U.S. Chamber of Commerce.

Mr. KATZ. Good afternoon Mr. Chairman. Thank you for inviting me.

Chairman BACHUS. Thank you. Welcome. And we have assembled this panel because we believe all of you have valuable insight into what direction both the Commission should go in and the Congress in addressing it.

Fourth, the Honorable Harvey Pitt, chief executive officer, Kalorama Partners, and former Chairman of the SEC. It is great to have you back.

Mr. PITT. It is good to be here.

Chairman BACHUS. I always enjoy your testimony and your insight.

And finally, Mr. J.W. Verret, assistant professor of law at Stanford University School of Law. And this is your first time to testify as a witness for the Majority.

Mr. VERRET. As a Majority witness, yes, sir. I have had a chance to testify nine times as a Minority witness.

Chairman BACHUS. It probably will be a very similar experience.

So we welcome all of you. And this 5-minute clock—if you need to take 6 minutes or 7 minutes, feel free to do so. We are not going to limit you. If you get up to 8 or 9 minutes, we might suggest that you wrap up. Commissioner Atkins, former Commissioner, we will start with your testimony.

Mr. ATKINS. Thank you very much, Mr. Chairman.

STATEMENT OF THE HONORABLE PAUL S. ATKINS, VISITING SCHOLAR, AMERICAN ENTERPRISE INSTITUTE, AND FORMER COMMISSIONER, UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Mr. ATKINS. Thank you very much, Chairman Bachus, Ranking Member Frank, and members of the committee for inviting me to appear today at your hearing. It is an honor and a privilege for me to be able to provide information for your deliberations regarding the organizational issues at the SEC. I would like to begin by congratulating this committee for taking up this issue of improving and enhancing the SEC. I have had the privilege of working there for a total of 10 years, first as a staffer in two Chairmen's offices, and then as Commissioner under three Chairmen, including Chairman Pitt, who is on the panel as well.

Because the public sector lacks the crucible of competition to winnow out inefficiencies and promote better management systems, I think it is periodically necessary for Congress and the President to step in to do so. A good example of this approach was what Congress in the Truman Administration took with the reorganization plan number 10 of 1950. In about one page, it gave the Chairman of the SEC clear authority over executive and administrative functions and radically reconfigured the SEC's governance in the process. Now in contrast to reorg plan 10, Dodd-Frank's 2,319 pages haphazardly addressed too many things and I think not very well. It created a grab bag of ideas that, through micromanagement, has made the management of the SEC much more difficult.

For example, Dodd-Frank added four statutorily mandated direct reports to the Chairman, the investor advocate, the Office of Minority and Women Affairs, the Office of Credit Ratings and the Office of Municipal Securities. Because these provisions are statutory, the chairman has little alternative to do things differently, especially since the chairman already has more direct reports than is practical. So these and other statutory provisions etched in stone one way of doing things to the exclusion of others.

Under Dodd-Frank Section 967, the SEC commissioned BCG to do a supposedly independent review of its management and organization. Unfortunately, this review does not appear to be independent, and I don't think it was very well done. And Jack Katz will give you a much more detailed critique of the BCG report in his testimony, which I have read and I subscribe to. But suffice it to say, I believe the taxpayer ought to get a refund of the $5 million or so that the SEC spent on that report.

I commend the committee for taking a fresh deliberate look at the organizational structure of the SEC with the draft legislation that is under discussion today. I also commend Chairman Bachus for proceeding in regular order, holding legislative hearings to gather commentary and consider openly the best approach before introduction of actual legislation. The committee correctly perceives that the SEC desperately needs organizational and management philosophy changes to increase efficiency and improve its regulation of the markets that it is tasked with of regulating, considering how dramatically the markets have evolved in the last decade or more.

With that said, I would caution against being too prescriptive regarding the internal organization of the SEC. Times and circumstances change, and the example of reorg plan 10 demonstrates that general guidelines, but with a firm sense of what the sense of Congress is, may be sufficient. But much depends on good managerial experience to lead the agency, which, of course, cannot be legislated.

The draft bill contains many good ideas. For instance, recognizing the second-class status of economists at the SEC and seeking to enhance their participation in policymaking and promote them to first class status I think is badly needed. The endemic problem is that economic analysis at the SEC has been performed as a post hoc exercise. The policy for rulemaking is mostly determined first by lawyers and only near the end of the process are the economists brought in to justify the actions on a cost-benefit basis. In this vein, I think Chairman Garrett's proposed SEC Regulatory Accountability Act is a very good step forward. The bill directs the SEC to utilize economists to determine whether or not to propose or adopt a regulation and to do so only after considering the costs and the benefits. The criteria set out in the draft bill are in the main commonsensical, and an economist worth his salt should take those criteria or similar ones into account.

The trouble is, at the SEC, cost-benefit analyses are usually done by lawyers in the rule-writing division and only shown to the economists at a much later stage. The SEC, after all, is an agency of, by, and for lawyers. Now this morning, Ms. Waters, Mr. Frank, and others raised the point regarding the applicability to enforcement cases of this draft legislation. That actually, I think, is a very good point. But it is an easy fix I think by carving out administrative orders and perhaps other things as we look at it. Even regulations mandated by Congress could benefit from such an analysis outlined in the draft legislation because the devil is always in the details, and the challenge is always to do the most for the least cost because the investor always pays for regulation through either higher prices or diminished choices.

Another area of potential reform required by Dodd-Frank is the SEC's oversight and reliance on SROs, most notably FINRA and the possible delegation of investment adviser oversight to an SRO. The committee, in fact, held a hearing a couple of days ago regarding this issue. Although the subject of an SRO for advisers is not necessarily the subject of this hearing, in my written submission, I raised concerns regarding expanding FINRA's empire without a fundamental re-evaluation of its statutory functions and organization. The subject of SEC funding often comes up in the context of discussing management failures at the SEC. It is far from a problem that is easily addressed by money or by creating new offices, as Dodd-Frank has done.

Madoff and Stanford did not result from parsimonious funding. Self-funding is certainly not a solution for these problems either. If the current leadership cannot handle leasing, as the chairman asserted in a hearing a couple of months ago, how in the world can it handle self-funding? There are many intelligent, competent, dedicated, hardworking people at the SEC. It is the management system and how it determined priorities over the past decade or more that has let them down. The system essentially is unchanged today. I salute this committee for taking on this issue and continuing a public discussion. In the past decade, the Securities and Exchange Commission's budget has increased threefold and the fundamental problems remain. Everyone in the current economic environment has to do more with less. And before the SEC gets any more money, I think it needs to show that it has garnered efficiencies and can use its billion-plus dollars well. So for the sake of investors who have lost billions in fraudulent schemes that should have been discovered earlier, it is high time that these organizational issues be addressed.

So thank you again for the invitation to come here today and testify. Thank you very much.

[The prepared statement of Mr. Atkins can be found on page 68 of the appendix.]

Chairman BACHUS. Thank you.

Mr. Crimmins?

STATEMENT OF STEPHEN J. CRIMMINS, PARTNER, K&L GATES LLP, AND FORMER DEPUTY CHIEF LITIGATION COUNSEL, DIVISION OF ENFORCEMENT, UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Mr. CRIMMINS. Thank you, Mr. Chairman. By last summer, most of the criticisms that are now being thrown by many at the SEC were already out on the table. All of this was long before we had heard of Bernie Madoff, before we had heard of Robert Allen Stanford, before we had heard of employees viewing Internet porn on company time, or the SEC lacking the same quality bookkeeping systems as the private sector. But Mr. Chairman, last summer we also heard that every year, through thick and thin, the SEC manages to file almost 700 complex securities cases against almost 2,000 defendants. How the SEC, with just 3,700 employees, reviews tens of thousands of disclosure documents each year while riding herd over 11,000 investment advisers, 5,000 broker-dealers, 7,500 mutual funds, a large collection of transfer agents, securities exchanges, rating agencies, clearing agencies, SROs and a market trading 8.5 billion shares a day.

So having already heard most of the same criticisms we are hearing today, but facing the worst financial crisis in 80 years, what did Congress decide to do? Congress last summer enacted legislation to double the SEC's budget in specified steps over 5 years. Now as you have noted, Mr. Chairman, and as Mr. Himes mentioned this morning, since 1996, the SEC has always been run entirely on noncontroversial Wall Street user fees, never spending a dime of taxpayer money. So the double budget would not have any deficit impact. After running the SEC on a shoestring, even with increases in recent years, still a shoestring for what they have to ride herd over, Congress wisely realized that to get out of the worst downturn since the 1930s, to promote growth, to create jobs, we need a securities market overseer that has the resources to make a difference.

Mr. Chairman, 12 months later, we still know pretty much what we knew last summer. But instead of actually moving forward getting that doubled SEC budget in place, we are hearing from consultants, albeit sophisticated talented consultants, about things like optimization initiatives, time-phased multiyear implementations, cross-workstream integration points. And we are forgetting, Mr. Chairman, that a wall-to-wall restructuring like this will effectively paralyze the SEC for a year, 2 years or longer. Endless meetings to plan and replan new reporting chains, job descriptions, reallocations of power and authority among SEC offices, staff members obsessing over resumes, and how to handle internal job interviews.

Mr. Chairman, I suggest that you got it right when you said earlier this morning, "heal thyself." Heal thyself, realize what you have to do, and do it. And Mr. Chairman, I would say, having heard Mary Schapiro this morning and others that we have heard in recent months, they get it. They get what has to be changed. And Mr. Chairman, you referred to some of the changes that Chairman Schapiro has effected. They get it. I say, Mr. Chairman, let's let them concentrate on their core missions and we know what those are: capital formation; market surveillance; and fraud detection. This is the worst of all possible times to do this kind of comprehensive reorganization.

At the same time, we can't freeze things in time. And Chairman Schapiro this morning talked about her concerns that the Modernization Act, while very well-intentioned and focused, might have that effect, that it might freeze the org chart and would take an act of Congress to change things. Mr. Chairman you commented that certainly you are looking for flexibility and this is a discussion draft and this is something that you want to consider further, as does the committee. You and Mr. Frank have both commented this morning about the need for flexibility, and we all appreciate that.

Another point, Mr. Chairman, in last week's Joint Session, the President urged us all to, as he put it, cut away the red tape. Cut away the red tape that prevents startup companies, those people in garages and warehouses and so forth, companies just in the starting phase from raising capital. We all want the SEC to write those rules, providing cheap and efficient procedures for America's small businesses to raise capital, to give us the growth we need and to give us the jobs we need. But procedures that still ensure that investors, obviously, get the information that they need on their own to make informed investment decisions.

But Mr. Chairman, I have a concern. My concern is that we can forget about this kind of rulemaking to streamline capital formation or anything else if we keep handing rulemaking opponents of all the ideological persuasions more and more tools to block anything that the SEC tries to do. Now Mr. Garrett's bill is, again, very well-intentioned and very thoughtful. But as a proposal, the

Regulatory Accountability Act would have an unintended consequence. It would let opponents file lawsuits to block any new rule by arguing that the SEC had failed to appropriately consider a whole laundry list of—and this is the key point, Mr. Chairman—vague factors that any plaintiff's lawyer can easily exploit. Things like, is it good for society? Sure, we want it to be good for society. Sure, we want a cost-benefit analysis. That is a given. Absolutely right. But do we want to give that to the plaintiff's bar as a tool? Regardless of what their particular persuasion is on a particular issue, do we want to give them that as a tool to just tie stuff up, and prevent these rules getting through that we actually do need?

Mr. Chairman, I think what hasn't been mentioned is that if you look at any SEC rulemaking, the release, the second half of it, dozens of pages are all about cost-benefit. They have the Regulatory Flexibility Act, the Paperwork Reduction Act, a whole bunch of stuff which holds their feet to the fire and makes them do this kind of stuff. That Court of Appeals case we talked about this morning is unfortunate. Maybe the economic analysis should have been better, as the judges said. But the point is, the execution. It is not pile on more requirements. Cost-benefit is clearly a requirement. It is clearly something they do. If they need to do it better to execute better in particular instances, absolutely right.

Mr. Chairman, a back-to-basics focus on the SEC's core missions of capital formation, market surveillance, and anti-fraud enforcement is what these difficult times demand, not micromanaging the SEC, not paralyzing it by piling on mandated multi-year reorganization studies and new requirements and procedures. It is time to let the SEC get to work.

In conclusion, Mr. Chairman, last summer, with all the recent criticisms already out on the table, Congress made a sound decision to double the SEC's budget. Again, using Wall Street user fees that are already available, that Wall Street is willing to supply. They are peanuts compared with the user fee that I pay to take my family on a relative basis into a national park, small user fees. Wall Street is okay with them, using those and no tax dollars—no tax dollars, no deficit impact to help get us out of this present crisis and do what we can to avoid future crises. Mr. Chairman, I would respectfully suggest to the committee that it is time to deliver on that promise and give the SEC that doubled budget. Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Crimmins can be found on page 81 of the appendix.]

Chairman BACHUS. Thank you, Mr. Crimmins.

Mr. Katz?

STATEMENT OF JONATHAN G. "JACK" KATZ, FORMER SECRETARY, UNITED STATES SECURITIES AND EXCHANGE COMMISSION, ON BEHALF OF THE U.S. CHAMBER OF COMMERCE

Mr. KATZ. Thank you, Mr. Chairman. Good afternoon. Good afternoon, Congressman Schweikert. Thank you for giving me the opportunity to participate in this hearing. As you may know, I spent most of my professional career at the SEC until I retired in 2006. I believe very strongly in its mission and I care deeply about its future. Since my retirement, I have had an association with the

Center for Capital Markets Competitiveness at the U.S. Chamber of Commerce, and it has provided me with an opportunity to continue to express my views and do what I can to support the agency.

I believe that the SEC must change in many ways. And for this reason, I consider the BCG report has really been a missed opportunity. The analysis and findings in the report are conclusions. They lack insight. They lack empirical foundation. Simply put, I think the report ends with recommendations that should have been the starting point of the report. For example, it recommends that the agency should consider reorganization. It recommends that the agency should examine its priorities and then consider how to realign its staff with these priorities. These statements should have been the starting points for the study, not its findings. During the past 2 years under Chairman Schapiro, the SEC has actually initiated some really significant changes in its operation. The report, however, fails to assess what has been accomplished, if anything. It just restates the changes in a general and uncritical manner. It fails to conduct a meaningful assessment. And in doing so, I think it has done a disservice to the Commission and to the people at the Commission who have spearheaded these changes. If these changes have had a positive impact at the SEC, a report that documented the benefits of these changes would have been really useful in restoring the credibility of the Commission.

Given the way I feel, I applaud you, Chairman Bachus for focusing attention on the need for reorganization in the SEC. It really is long overdue. The current structure is antiquated. It is cumbersome. It is largely based on a design to regulate the U.S. capital markets in the 1970s, not the markets of today. In addition to being antiquated, it places an unrealistic burden on the Chairman. The CEO of any organization should not have 20 direct reports. Reorganization by itself isn't going to solve any all of these problems. But an intelligent reorganization structured properly can really contribute measurably to a stronger agency. So while I support the objectives of your proposal, I believe that the focus of the legislation should be reoriented.

I think Congress must be responsible for determining the authority and powers of a government agency. It should be responsible for monitoring agency performance, for holding the agency accountable for its actions. And it is the responsibility of the government agency for execution of those policies and implementation of its responsibilities. And this necessarily should encompass organizational structure and the assignment of duties, for the same reason I believe that the Dodd-Frank provisions requiring the creation of five new offices is a mistake that should be corrected.

I have a second concern with reorganization through legislation. The reality is, no organization with charges are ever perfect. Agencies to be effective must change over time. If the structure of the SEC can only be changed by an act of Congress, we would be exacerbating the problem we already have. An agency that is already slow to adopt a change in markets would become even slower to change. And I have a similar perspective on Congressman Garrett's bill. I support his efforts to improve the quality of SEC rulemaking by clearly specifying the components of a careful analysis of a rule's costs and benefits. But I worry that a pre-adoption cost-benefit analysis will always be fundamentally limited in what it can achieve. It requires the staff to estimate the impact of events that have not yet happened.

A regulator rarely has the capacity to predict with certainty how individuals or firms will respond to a new rule. If the regulator can't predict the response, it is difficult to accurately quantify the cost of compliance or the value of benefits. For this reason, I believe in a different approach. I would combine the preadoption cost-benefit analysis with a post-adoption look-back requirement for the SEC. In my written statement, I have a detailed explanation of how I think this could be implemented. My written statement also has several other suggestions for how Congress could act to facilitate and contribute to an SEC turnaround.

In closing, I just want to briefly mention two of them. The first is an amendment to the government in the Sunshine Act that would permit two or more Commissioners to meet informally with Commission staff to monitor staff activities and participate in the early discussions where the action really is concerning formulation of Commission rulemaking policy. In 20 years as Commission Secretary, I had the privilege of working for seven Chairmen, four acting Chairmen, and almost 20 Commissioners. Every one of them, at some point in time, expressed deep frustration with how the Sunshine Act was preventing them from really doing their job to the best of their ability.

The second recommendation that I want to highlight is the need for creation of a special study team to engage in a systematic and comprehensive review of the U.S. capital markets and our regulatory system. The first special study was completed in 1963. In an 18-month span, it produced a 5-volume report that really was the basis of the development of our current national market system. And that study provided what I considered the intellectual touchstone for really the next 20 years of enlightened, progressive, and dramatically changed SEC regulation. I think the time is right now for another special study. And thank you for this opportunity to speak today.

[The prepared statement of Mr. Katz can be found on page 86 of the appendix.]

Chairman BACHUS. Thank you, Mr. Katz.

Mr. Pitt?

STATEMENT OF THE HONORABLE HARVEY L. PITT, CHIEF EXECUTIVE OFFICER, KALORAMA PARTNERS, LLC, AND FORMER CHAIRMAN, UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Mr. PITT. Chairman Bachus, thank you for your invitation to discuss the legislative proposals that are clearly intended to improve and enhance the performance of the Securities and Exchange Commission, and the performance needs to be enhanced. I commend you and the members of this committee for holding this kind of a hearing and for the important consideration this committee is giving to ways to improve the SEC's effectiveness. To assist the committee, yet stay within the time restraints that you have asked us to respect, I would like to briefly raise five overarching points for your consideration, and I will leave the details in my written statement.

First, the SEC is vital to the proper functioning of this country's economy and capital markets and has been given an extraordinary and ever-increasing mandate over the past 77 years. These days, the agency's mission is often overlooked and its successes are often ignored. Instead, the SEC has been converted into an institutional pinata, attacked whatever it does or what it doesn't do. The SEC has made some significant and serious mistakes. But it is taking steps to correct the perceived weaknesses. Second, enhancing the Commission's effectiveness is a proper and important goal. The agency must improve its organizational structure and efficacy, but it cannot and should not do so without the constructive assistance and oversight of this committee.

And yet accountability, efficiency, and effectiveness, while concepts for which the agency must strive—and I encourage those efforts—can also be an effective euphemism for creating impediments to the agency's ability to meet these goals. Third, sustainable change in agencies as well as in individuals can only come about if the agency embraces the need for change and the proposed way in which change should be effected. This does not give the agency the right to thwart Congress' directives. But no amount of legislation can force a change in the agency's culture or performance unless the agency and its employees embrace both.

Fourth, without ignoring the instances in which the agency failed to meet legitimate expectations, public attacks on the agency's bona fides, the potential failure to give it appropriate resources and the assumption that the agency can't even get wrong right can demoralize those whose participation in sustainable change is crucial and ultimately prevent this committee from achieving its very laudatory objectives. Fifth, the SEC must do better and change. It has too important a role to play.

Principal among the requirements, I think, is for the agency to be creative in figuring out how to meet its new responsibilities, including those under the Dodd-Frank Act, without receiving any additional funding. One such way is effectively for the agency to improve its compliance examination function, the very function that did not capture the Madoff and Stanford Ponzi schemes. It could do this if Congress gives it the authority to require every money manager to be examined either yearly or, in the case of smaller firms, every other year at no cost to the taxpayer by an independent expert group that would do an examination pursuant to standards the SEC could create. We proposed this policy in February of 2003 when I was Chairman, and it, I think, will offer some very valuable opportunities to get better examinations and perform what I would call compliance audits in the same way financial audits are performed.

Of course, we have financial audits and that doesn't prevent financial frauds, and compliance audits won't prevent compliance frauds. But this will allow the agency, if it gets reports on all of these examinations, to focus its attention to see new trends as they are arising and effectively be able to do the kind of oversight it should do with no burden placed on the American taxpayer. That, it seems to me, is the kind of creativity that the agency has to now come up with and be in the forefront of efforts to achieve.

I appreciate this opportunity to discuss these important issues, and I will try to respond to any questions you have. And I also offer, without meaning to sound presumptuous, to make myself available if there is any way in which I can assist this committee in its very important work. Thank you.

[The prepared statement of Mr. Pitt can be found on page 101 of the appendix.]

Chairman BACHUS. Thank you.

Let me say this to all of the witnesses. We plan to give all of you an opportunity to not only give your testimony today but to continue to advise us, as we go forward. Professor Verret?

STATEMENT OF J.W. VERRET, ASSISTANT PROFESSOR OF LAW, STANFORD UNIVERSITY SCHOOL OF LAW, AND SENIOR SCHOLAR, MERCATUS CENTER, GEORGE MASON UNIVERSITY

Mr. VERRET. Thank you, Chairman Bachus, and distinguished members of the committee. I appreciate the opportunity to testify. My testimony today will focus on two important and necessary reforms. First, I will argue that clarifying the SEC's legislative mandate to conduct economic analysis and a commitment of authority to economists on staff at the SEC are both vital to ensure that new rules work for investors rather than against them. Second, I will urge that the SEC be required to consider the impact of new rules, particularly corporate governance type rules, on the State-based system of business incorporation.

Every President since Ronald Reagan, including Presidents Clinton, Obama, and Bush, have requested that independent agencies like the SEC commit to sincere economic cost-benefit analysis of new rules. Further, unlike many other independent agencies, the SEC is subject to a legislative mandate that it consider the effect of most new rules on investor protection, efficiency, competition, and capital formation. The latter three principles have been interpreted as requiring a sort of cost-benefit economic analysis using empirical evidence, economic theory, and compliance cost data. These tools help to determine the rule's impact on stock prices and stock exchange competitiveness and also measure the compliance costs that are passed on to investors. Three times, three times in the last 10 years, private parties have successfully challenged SEC rules for failure to meet these requirements, for failure to make the grade. Over the three cases, no less than five distinguished judges on the D.C. Circuit appointed during Administrations of both Republican and Democratic Presidents found the SEC's economic analysis severely wanting and insufficient. One failure might have been an aberration. Three failures out of three total challenges is a dangerous pattern. Many SEC rules have treated the economic analysis requirements as a mere afterthought. This is in part or a consequence of the low priority the Commission places on economic analysis, evidenced by the fact that economists have no significant authority in their rulemaking process or the enforcement process. And I realize that rules have a section called cost-benefit analysis. But having it there is no substitute for having quality analysis.

As an example of the level of analysis typically given to significant rulemaking, consider the SEC's final release of its implementation of a very controversial and often reviewed rule, Section 44(b) of the Sarbanes-Oxley Act. The SEC estimated that the rule would impose—this is at the time the rule was adapted—an annual cost of $91,000 for a publicly traded company on average, $91,000 was their best guess. In fact, a subsequent SEC study 5 years later found average costs of $2.87 million per company. That is missing the mark in a big way. That error in judgment only applies to estimates of direct costs. The SEC gave no consideration to the more important category of indirect costs and the much larger category of indirect costs, like the impact of the rule on the volume of new offerings or IPOs on U.S. exchanges. In *Business Roundtable* v. *SEC* alone—this is the most recent challenge—the SEC estimates it dedicated over $2.5 million in staff hours to a rule that was struck down. That represents an estimate of about $100 an hour for SEC time. Now for securities lawyers of that experience, I think most would agree that $100 an hour is probably a very conservative estimate of the hourly opportunity costs of their time. But let's assume that estimate, $2.5 million in staff hours. An honest commitment by the SEC to empower economists in the rulemaking process will be a vital first step to ensure the mistakes of the proxy access rules are not replicated in future rules.

I also support the goal in H.R. 2308 to further elaborate on the economic analysis requirements. I would suggest in light of the importance and pervasiveness of the State-based system of corporate governance that the bill include a provision requiring the SEC consider the impact of new rules on the States when rulemaking touches on issues of corporate governance. The U.S. Supreme Court has noted that no principle of corporate law and practice is more firmly established than a State's authority to regulate domestic corporations. Delaware is one prominent example, and it is the State of incorporation for half of all publicly traded companies. Its code is so highly valued among shareholders that the mere fact of Delaware incorporation typically earns a publicly traded company a 2 to 8 percent increase in value. Many other States also compete for incorporations, like New York, Massachusetts, California, and Texas.

In order to fully appreciate this fundamental characteristic of our financial market system, I would urge adding the following language to H.R. 2308, "The Commission shall consider the impact of new rules on the traditional role of States in governing the internal affairs of business entities and whether it can achieve its stated objective without preempting State law."

The SEC can comply with this requirement by taking into account commentary from State Governors and State Secretaries of State during the open comment period. It can minimize the preemptive effect of new rules by including references to State law where appropriate, similar to one already found in Section 14(a)(8) promulgated under the Exchange Act. It can also commit to a process for seeking guidance on State corporate law issues by creating a mandatory State court certification procedure, similar to the one that was voluntarily used by the SEC in the *AFSCME* v. *AIG* case in 2008.

Now we have heard a number of comments from some members about the importance of the financial crisis and the importance of tail risk. I would note that regardless of litigating the merit of items of the Dodd-Frank Act, a number of items in the Act were unrelated to the financial crisis and were unrelated to issues of systemic risk, particularly in the securities regulation area. The Dodd-Frank Act was a big bus coming through Congress and there were a lot of old ideas that had been germinating for 10 years, particularly with proxy access, that got on the bus.

Proxy access was essentially a union-driven special interest item that managed to get tagged on. I have done some independent analysis with an econometrician at the economics department. We studied the impacts on a very small subset of firms, a few hundred firms, and found that proxy access caused actually $500 million in losses for just a few hundred firms, as of the event date of August 25th—and I will be happy to submit the full study to this committee. So I think this is a very important issue to consider, and I appreciate the opportunity to testify. I also want to clarify on a personal note and correct a very serious error in a prior testimony during the DFA hearing on this issue on proxy access, I represented to Congressman Frank that I was a Red Sox fan. And in the interim, I have been lucky enough to marry a Phillies fan. So I want to go on the record as saying I am a Phillies fan and correct that prior error in my testimony. Thank you.

[The prepared statement of Professor Verret can be found on page 141 of the appendix.]

Chairman BACHUS. He would say you went over to the dark side. Thank you.

I think most of your testimony was pretty clear, and I don't have any questions about what you testified. One thing that I do want to ask you—you have not testified about this, but I would like an answer to it. The Stanford case, we have talked about the SEC and the failures of the SEC in the Stanford case. As I understand it, it was a financial product, not a security, and that it was actually advertised as a foreign-based product. What effect did that have on the SEC? Their jurisdiction on it was somewhat clouded, I would think. And I am just trying to get a handle on that. Can anybody comment on that? I am not sure I articulated that right. But it was not a security. It was a financial instrument.

Mr. PITT. Yes. Certainly when the SIPC issues came up, the claim was that they were banking and financial entities, not brokerage firms; and therefore, there was no coverage. But if I am not mistaken, the SEC did file a lawsuit in which it alleged fraud on the part of an entity it claimed was acting as a broker-dealer. And so I think the SEC found jurisdiction. The real issue was what happened between the years when this Ponzi scheme was going and when it finally came to light and whether or not the process used was effective. But I think they came up with sufficient authority.

Chairman BACHUS. Right. And I think that they obviously did have jurisdiction. But I am saying, did that cloud some of the initial investigation or enforcement? If you look at the perspective—it has been some time. There was a representation that they were buying something foreign.

Mr. KATZ. Mr. Chairman, if I can add something. I have always believed that Stanford was actually, in the perspective of what happened in the SEC, a far more troubling instance than Madoff.

Chairman BACHUS. Okay.

Mr. KATZ. And if I could make a comparison. In Madoff, the staff were presented with information and they dropped the ball. They didn't see it, and they didn't figure it out. What troubles me with Stanford is, if you look at the facts as they have been made public, the examination staff in the Fort Worth regional office spotted it. They recognized it as a potential Ponzi scheme through their examination program, and they tried very hard to get the enforcement staff to follow up. And for a variety of reasons, the enforcement staff had no interest in it. This was not a legal issue. This was not a question of authority. This was a question of staff making a bad decision when other staff in the Commission were saying, this could be a very serious problem.

Chairman BACHUS. Right. In fact, some of that staff was then let go who made the recommendation to go forward. So I do believe there is something there that—

Mr. KATZ. If I could just tie it into a broader theme. Metrics count. Staff do what they are evaluated on. And I have written in a law review article a couple of years ago that one of the problems of the Enforcement Division was it used the most simplistic measure of performance, which is, how many cases did you bring? A nickel-and-dime case was one stat. A massive investigation was one stat. And that there were offices that knew how to game the system, and they realized, we can devote four or five people for several years to this really complex difficult case and have one case to show for it. Or we can bring 5, 10, 15, or 20 smaller cases and sort of really knock the ball out of the park when it comes to our evaluation.

And that was what I think happened in Stanford. They looked at this. They saw, this is a huge complicated case. We are a small office. If we try to take this case on, we are just not going to bring as many cases. And to me, that is the management problem at the SEC that Stanford illuminates.

Chairman BACHUS. Right.

Mr. ATKINS. Just to chime in there too. I am not up to date on the Stanford case. It is obviously being litigated and everything else. So I wouldn't want to really weigh in on that. But I do agree with what Jack Katz was just saying, that the real problem which the BCG report didn't really address, the elephant in the room is, how does one gauge whether an enforcement attorney or the enforcement program or what have you, is successful, and what does success mean? How do you measure what the SEC does? When you look at the simple number of cases brought, that is not really a fair gauge. For all the reasons Jack said, it is easy to goose the numbers every year. There are cases called the 12(j) cases where the SEC brings accounts as a statistic, and that is simply where a company should no longer be listed. It is forcibly delisted.

Every year, that is 100 or more cases that sort of add to the—it is a good way to make the numbers look better. So I think that is one real challenge with respect to how to run at least the enforcement program and to a lesser extent the examination program.

Mr. CRIMMINS. Mr. Chairman, if I could weigh in also. I think you were exactly right in terms of overlapping jurisdiction. If you have a Stanford where maybe the securities jurisdiction, if you posture it the right way. But there were also the banking agencies and various other financial services agencies. Things can drop between the cracks. One agency can figure, well the other one—it is passing muster over the other agency. I think you hit the nail on the head, Mr. Chairman. When you have overlapping jurisdiction, there can be those issues. But also, the other short point I would make is the competing priorities. We had Madoff hit and Stanford hit. In the midst of other stuff, we had the Enron WorldCom crises; we had the market timing and late trading in mutual funds is a big deal; we had option back dating sweeping corporate America; we had all these things where they had to pile on all the troops, keep up with the New York attorney general, keep up with FINRA. And when somebody walks through the door, as diligent and hardworking and sincere as Mr. Markopolos absolutely is, and he walks in the door and says, hey, I have a hot one for you, it is the former Chairman of FINRA, the guy who also was the vice chairman of the industry, securities industry association, and he is a fraud.

And meanwhile, that particular office of the SEC is in the midst of running to catch up with other regulators and to keep up with other regulators on late trading and market timing, it is a question, to wrap it up, Mr. Chairman, about competing priorities in an agency run literally on a shoestring, with half the budget it should have, especially post-1996 when we took it off the taxpayers' backs and made it Wall Street user-fee-funded. It needs double the budget. It needs to deal with those competing priorities. That is how it will deal with the Madoff situations. That is how it will deal with the Stanford situations going forward. Thank you.

Chairman BACHUS. One thing—and I am going to give all questioners 10 minutes. Several of you had referred to them focusing on what their job is. One of my concerns has been that they and really all the Federal agencies have been papered and run to death. They are spending tremendous amounts of resources just reporting to Congress, which is a legitimate function of the Congress. But in the draft that I proposed, it would allow the Chairman—several of you indicated she ought to be free to do her job or his job, whomever it may be—and we reduce, I think, from 24 to 14 the number of people who report to her. But I think it is a problem. And you do see that the CEO or the Chairman ought to focus on fewer things and more important things and the vision.

Let me ask each of you this: Does anyone disagree that because of the added jurisdiction, there is a need for more money? There is expanded jurisdiction. Would we all agree there is an expanded jurisdiction for—

However it comes, through an appropriation or through user fees, can a reform happen without money, without additional funds? I would ask that. And I am saying that a condition to additional funds ought to be a reform, but just give me a comment there.

Mr. ATKINS. I do think that reform can happen without additional funds because it depends on what—we are talking about here managerial reforms, we are talking about how do you manage an agency to try to incentivize people to do the best.

I remember sitting in a senior staff meeting one year where certain senior staffers from certain divisions asserted that everyone in their division ought to get a merit bonus, regardless of who they were, but it had to be equal throughout. An interesting concept that I don't think is duplicated in the private sector. So that is just one indication of how managerial attitudes probably need to change, and again things like that were not—

Chairman BACHUS. And I am sure the employees union and some of those present some challenges having to do with it.

Mr. ATKINS. Perhaps. But this was coming from senior staff people who were saying that in their division, they thought that it would be untenable to differentiate between people. Some other divisions disagreed, of course, but some were taking that tack.

Chairman BACHUS. Sure. And I disagree, too, with that thought, that they ought to all get a merit bonus.

Mr. VERRET. I would just express agreement with that, and also add that reform can also save money. And with respect to the debate over funding, I would just note also that the taxpayer, though taxpayers don't fund the SEC through taxes, they are the residual beneficiary of the user fees. So to that extent it certainly—it is a relevant discussion. And there is some debate over funding the SEC and how much and such, but part of the discussion ought to be the fact that the taxpayer is a residual beneficiary, and so the debt and deficit discussion does play in, at least tangentially, to that discussion.

Chairman BACHUS. Right. And obviously if they don't have the resource, there is often a cost from not doing something, which is—

Mr. PITT. Part of the difficulty, I think, is there is no agency that has ever been created that won't tell you that they could use more money.

Chairman BACHUS. Right.

Mr. PITT. They all want it. So one of the issues is, how do you manage what you have? I think, first, the SEC's increase in responsibilities has been so large that there is a huge gap; but, second, I think that there are ways in which the agency can save money, such as the one I mentioned on the examination process, that would actually do better for America's investors than what the SEC is able to do. And somebody has to be thinking creatively to try to come up with those ways. I think both things have to be done in order to make sure that the resources the agency does have are used appropriately.

We are at $1.1 or $1.2 billion. When I took over, our budget was about $300 million, and it was a lot of money, although we needed more, of course.

Mr. KATZ. Excuse me, Mr. Chairman, if I can echo and expand on what Harvey just said. I was at the Commission for a long time, through the fat times and the lean times, and I remember after Boesky in 1986, the budget of the agency doubled. And then there was a period in the early 1990s, after the passage of the Remedies Act, where the Commission got a huge increase in its funding. Harvey mentioned when he was there, and there was also a similar increase.

Economists have a phrase, they refer to something as being necessary but not sufficient. My problem with increased funding is I absolutely believe it is necessary, and I absolutely believe it is not sufficient. What I saw happen when the agency got these huge budget increases was it enabled them to avoid taking a hard look at what it was doing well, and what it was doing poorly. So that when the Enforcement Division got a massive increase in staff and everybody said, good, now they will have the resources to do more complex, difficult cases, and they will do them faster, sadly that is not what happened. More staff just meant they brought more cases, not necessarily better cases.

Additional funding is absolutely essential, but it is absolutely essential that it be coupled with substantive internal change in what the agency does and how it does it creatively. Harvey's idea is just one of a number of examples of ways the agency could be imaginative in its use of resources.

Chairman BACHUS. Right. In fact, I will say this, and I think it is very important, I think that is an important point; that increased funding can actually mask the need for reform or retard reform. Sometimes you confront and decide what is the most important and prioritize. That is true not only of a government agency or a corporation, but also of a family.

Mr. PITT. I would say, Mr. Chairman, that is an area where I think the Commission would benefit from outside help. When we would look at the budget, the first thing that a Chairman is told is, that is sacred, we can't touch that. And if you start to ask questions about why it is sacred and why it can't be used, you don't always get great answers. I think that it is important to have somebody outside the agency look at how the agency can use its resources more efficiently, not change the resources, but use them more efficiently and determine whether or not subsequent increases are going to be necessary.

Chairman BACHUS. Thank you. Of course, you know that Congressman Frank indicated earlier in this hearing that he realizes that there needs to be some rollback on some of the charges or the responsibilities that have been assigned to the Commission by Dodd-Frank. He has acknowledged that could be reviewed.

Mr. CRIMMINS. Mr. Chairman, if I could just add, it is certainly something to consider the new jurisdiction, the expanded jurisdiction, the new duties and burdens put on the SEC by Dodd-Frank, as you have indicated and as Mr. Frank has indicated. But I would also respectfully ask the committee to consider how the old stuff that the SEC has to deal with has radically changed in the last 10 years. And what I am talking about, Mr. Chairman, is high-speed computerized trading. We just didn't have that 10 or 20 years ago where computers, without consulting a human being, can put in huge orders, change them, test price, change—they get so far ahead of the average retail investor that it is a totally different market.

That has to be—that costs a lot of money to get the sophistication and the people you need on top of it, to get the technology on top of it, so you can see the markets in real time; and not only that, volume is soaring through the roof where it is 8.5 billion shares daily, hugely bigger markets than we ever had before.

And then lastly, Mr. Chairman, the complex new products that we have before—we talked about derivatives earlier today, all kinds of complex new products, complicated stuff that sometimes the people who create them don't even understand them. That is the old stuff and how it has radically changed.

So, again, Mr. Chairman, thank you for being open to those additional resources that this Commission really needs.

Chairman BACHUS. Thank you. You are obviously right. We were dealing with products that it was hard for people who were trading them or constructing them to explain what they were.

Mr. Frank, you have 20 minutes of questioning.

Mr. FRANK. Do I have to use it?

Chairman BACHUS. As much as you want.

Mr. FRANK. Thank you.

Chairman BACHUS. And then the two, Mr. Schweikert and Mr. Manzullo.

Mr. FRANK. Maybe I will take 6 or 7 minutes. I thank the witnesses for staying with us. I think this has been a very useful hearing. I am trying to go back and—Mr. Pitt, was it your statement? I am trying to find it again. One of the—I apologize, I read this, maybe it was Mr. Atkins had some concerns about FINRA. Was that Mr. Pitt or Mr. Atkins?

Mr. ATKINS. That was me.

Mr. FRANK. I am interested in your concerns about FINRA, and also obviously one of the key questions for us is what is the appropriate devolution and interrelationship between the public agency and self-regulatory agencies? There are great advantages to self-regulatory agencies, but there are some problems and limitations. Would you expand a little bit on your problems with FINRA and how you think we should be generally moving the structure of these relationships?

Mr. ATKINS. Yes, sir. Thank you. Yes, I put that in. I wasn't, obviously, at the last hearing, but we need to look now at, I think, how self-regulatory agencies operate in the current climate. You have SROs, historically were the NASD and then also the various markets. Now the markets are for-profit agencies, for-profit companies, and so I think a lot needs to be done to step back and really look at whether a for-profit company should still be categorized as an SRO with all the paraphernalia that goes with that as far as rule approvals and that sort of thing, especially when you compare to the CFTC and how on that side rules are approved or not.

With respect to FINRA, it is now basically a monolithic, monopolistic regulator of broker-dealers. Everyone has to be a member of FINRA. In the old days, you could be an SEC-only registered broker. So, the world has really changed, and my point is, before you designate an SRO, like FINRA, it could still be an SRO, then, you need to take a step back and look at it.

Mr. FRANK. I appreciate that. Let's look at—would it be that you would find some of these, if they were for-profit, inherently inappropriate to be given these responsibilities, or would you write a code of conduct that was binding from the SEC that protected the rights? I mean, you have the State actor issue there. Which general direction would you go in?

Mr. ATKINS. For the most part, the for-profit agencies have bifurcated their enforcement arms, and a lot has gone over to FINRA. They still retain oversight over their market itself, but they still are subject to SRO-type of regulation with respect to rules and that sort of thing.

Mr. FRANK. Would you tighten them? Should we get more explicit when you talk about—

Mr. ATKINS. You could actually do the opposite of tightening them. You could still have the SEC oversee it, and then ultimately wield the regulatory hammer if things are noncompetitive or something like that, but you could take it—to make things more streamlined, you could take a page from the futures industry. But with respect to the State action of FINRA, the closer that it gets to being the only—

Mr. FRANK. How close is it now, would you say?

Mr. ATKINS. If you look at the Quattrone case, I think that is an indication of where things could go.

Mr. FRANK. Do you think—I am trying to get your opinion, not your commentary on others.

Mr. ATKINS. Right. I won't say that it is a State actor. I think there have been some really good points that have been written, some articles, and I would be happy to forward them to you, but I think it is very dangerously close to becoming a State actor, and so that is why I think that—

Mr. FRANK. But not yet? I mean—

Mr. ATKINS. It probably depends on the case. It depends on how FINRA acts within, like Quattrone.

Mr. FRANK. Oh, okay, but then the answer is they are to some extent, they are a State actor, if—given that, they are a State actor. They may not act like one in a particular case, but given what you say, they should be treated as a State actor.

Mr. ATKINS. With the proper challenge, I think they could be found that.

Mr. FRANK. Mr. Atkins, you are surprisingly tentative for someone who is no longer in the job. Should we treat them as—should they be treated as a State actor or not in their current form?

Mr. ATKINS. If they remain a monopolistic type of regulator—

Mr. FRANK. As of today.

Mr. ATKINS. I am sorry?

Mr. FRANK. If they are not—if a year from now, they look the same way they look today, should they be a State actor?

Mr. ATKINS. Again, I will just say, given the right case—I don't want to say yes or no.

Mr. FRANK. Obviously, you don't. I don't know why, though.

Mr. ATKINS. Sorry.

Mr. FRANK. Let me ask Mr. Verret, on the question of preemption, you say the Garrett bill should be changed to say the Commission shall consider the impact of new rules on the traditional role of States in governing the internal affairs of business entities and whether it could achieve its stated objective without preempting State law. But of course, the Garrett bill is not confined in its subject matter, only the matters of governance. Should we not, then, put that in there for all matters of preemption, or would you—should we worry about preemption only of State governance laws and not of other State laws preempting other things? Why not just say, "shall consider the impact of new rules on States and whether it continues its stated objective without preempting State law?"

Mr. VERRET. I would answer with a very simple distinction that there are some types of preemption that are beneficial and some that are not. I think there was some bipartisan support, for example, for the National Securities Markets Improvement Act in 1996 because that tied—

Mr. FRANK. But you are cutting to a substantive—

Mr. VERRET. —to official. And I think just to answer your question about the reason why I focus on corporate governance is because that type of preemption deals with the type of regulation in which States internalize the cost of their—

Mr. FRANK. Mr. Verret, that is not what I asked you, and I understand. I am not asking you for the substantive view. People have different views, although I must say, I tell you, with a lot of my colleagues, a lot of us, people invoke States' rights versus national, preemption versus not. And my sense is that for many people, the decision on at what level of government a policy should be set depends on where they think they are likeliest to get the outcome they want, which by the way is perfectly reasonable. I don't think there is any kind of fundamental moral principle here. People should just acknowledge that. So I understand there will be differences.

But you haven't answered the question I asked you. You have told me why you want to talk about governance, but would you object to broadening that, or would you have us consider the impact on preemption only of governance, or would you have a more general requirement in the list of things to be considered the impact on the State law?

Mr. VERRET. To the extent you want to generalize it, what I would—

Mr. FRANK. No, I don't—excuse me, I don't want to generalize it.

Mr. VERRET. I would object to generalization on the following grounds.

Mr. FRANK. At least two of you are an unusually deferential panel. It is okay to tell us what you think. I am asking you what you think. This is your language, you want to do it for State governance. Would you cover—would you have that cover preemption in general, not for or against it, and because this doesn't say for or against it, although it does have somewhat of a nonpreemption leveraging. It says, can you do it without State law? But would you agree that this should be a general position with regard to preemption?

Mr. VERRET. I would not agree on the grounds that I think that in some instances, some States internalize the cost of regulation better than others. For example, in the creation of business entities like in Massachusetts, the creation of investment trusts, I think that the State does a good job of internalizing the costs and benefits. If it becomes suddenly a bad signal to be a Massachusetts investment trust, I think that your Secretary of State will internalize that, your legislature will internalize that, and that is why—

Mr. FRANK. But that is not a matter of corporate governance.

Mr. VERRET. —corporate governance specifically. The governance of investment institutions is certainly—

Mr. FRANK. You would cover only corporate governance?

Mr. VERRET. I would cover the creation of business entities and their internal affairs, which would also apply to Massachusetts investment trusts—

Mr. FRANK. I'm sorry, but I—

Mr. VERRET. —as well as corporate—

Mr. FRANK. I am less parochial than you might think, but I still don't understand the answer. Would you think that is covered by corporate governance or would you expand it to cover that?

Mr. VERRET. I think it would be—the focus on business entities I would define very broadly.

Mr. FRANK. So you think that what you just said would be covered by your own language here?

Mr. VERRET. Yes, I think so, yes.

Mr. FRANK. All right. But you wouldn't broaden it beyond that? I guess I am somewhat troubled, not troubled, but I am concerned, that in other words, you force some preemptions and not others, so you—it is okay—

Mr. VERRET. —when it is efficient and not others along the line—

Mr. FRANK. I understand that.

Mr. VERRET. —cost-benefit analysis.

Mr. FRANK. And I can understand coming down in the end on that, but I don't understand saying that you should only consider it in some cases and not others.

Mr. VERRET. Because in some cases—

Mr. Frank. I think you are putting—

Mr. VERRET. —it is sufficient and in some cases it is not.

Mr. FRANK. Excuse me. You are writing the conclusion into the procedure, and I am always troubled by that.

Mr. VERRET. I am just trying to write the conclusion based on sufficient economic analysis, and there is sufficient economic literature on the nature of corporate federalism and States.

Mr. FRANK. And there is no other preemption, you don't think there is any significant, any economic analysis anywhere else?

Mr. VERRET. That is a broad statement, "no other," but I think that—

Mr. FRANK. That is what your language says.

Mr. VERRET. I would not—I would broaden it, keeping in mind that some types of preemption are beneficial and some types—

Mr. FRANK. I understand. But again you are merging—and I think people too often do this—the procedural and the substantive. I can understand people say, yes, this preemption is good and that one isn't, and there is no principle that says that is necessarily bad, but I am just surprised that—I am not surprised, but I think saying we will only look at preemption in those cases where I think preemption is going to be bad, and not look at it elsewhere, writes people's policy conclusions into procedures, which is not a good idea in the—

Mr. VERRET. I would start here, and if you have other ideas about—

Mr. FRANK. No, I don't have any ideas.

Mr. VERRET. I would be glad to discuss this with you as well.

Mr. FRANK. I thought that is what we were doing, Mr. Verret.

Mr. VERRET. So what other—

Mr. FRANK. My point is, my substantive point you resist, you are writing a procedure which embodies your policy preferences, and I think that is a bad idea in the law. I think if there is going to be a procedure, it should be policy neutral and should apply to the whole topic. That is what we prefer.

Mr. VERRET. My own policy preference is efficiency.

Mr. FRANK. That is all, Mr. Chairman.

Mr. SCHWEIKERT. [presiding]. Thank you, Ranking Member Frank. It is always exciting when you come visit.

Mr. FRANK. You have to get a life, David.

Mr. SCHWEIKERT. I hear that a lot. Actually—and this is something I just wanted to share quickly—on occasion, when you look out and you see not a lot of bodies in the room, understand there are a lot of eyeballs watching us, as you walk through some of the different rooms, we are up on the television cameras in lots of different places.

I wanted to do a huge sort of back step and help me do something sort of conceptually, and I will start with the professor. Professor, if you were starting with a clean slate from a regulatory standpoint, and not just the SEC, but some of the other agencies that also dip their toe into this world, considering that the chairman is starting to put together a package that would have I think $100 million for additional technology, and living in the age of the Internet, if we were starting from scratch, what would a regulatory environment look like?

Mr. VERRET. I would start with the principle that government actors as well as individual actors are at their best when they compete; that when we compete for resources, that when we compete for people to join our group, whatever that might be, we are at our best. And so, I would look to the principles of regulatory competition. I would look to reform of SROs, reform of the SEC, potential creation of SROs, with all of that in mind. And I think that I am in agreement with former Commissioner Atkins on that issue, and I think that to the extent we consider creation of new SROs, we should consider making them, making membership voluntary and giving more deference to voluntary membership organizations rather than mandatory organizations, for instance exemptive relief based on—I know you asked me to start from a clean slate, but it is hard to think of that sort of state of nature.

Mr. SCHWEIKERT. Part of the nature of the question is as we are moving, and the actual, Chairman Schapiro, as they start to move much more of their platform to Web-based access of information and those things, I am just trying to get my head around what would truly be the optimal, if we had started from scratch, and could we possibly move that direction.

Mr. VERRET. I hope so. That is a very broad question.

Mr. SCHWEIKERT. Okay. And maybe it is just too far theoretical. Chairman Pitt, am I living in fantasy land? Which I get told often, as we just had mentioned.

Mr. PITT. No, I think it is an appropriate question. I am not sure whether you are asking just about the jurisdiction of, say, the SEC and self-regulatory bodies or all of financial regulation.

Mr. SCHWEIKERT. I would actually go from almost all types of financial regulation.

Mr. PITT. Yes. I think we have a terrible system of regulation, and I think we missed an opportunity to create a better structure. The current structure is based on what you were born as or called at birth. It doesn't depend on what it is you, in fact, do. So we had banks that were doing securities work, but they are regulated as banks. We had securities firms that were doing banking, we had mutual funds that were doing all of that, and depending on what they were born as, that is how they got regulated. That is, in my view, not the kind of system that we ought to have.

We should have a central regulatory system for financial services, and the only things that I would exempt out of that are: first, monetary policy; and second, systemic risk. Those two issues I would give to the Fed, but I would divorce the Fed from all of its banking regulation and put that in a central repository of all financial regulation. Then you can have functional regulation as well as prudential regulation. I don't think we will ever get there, but I think it would be great to imagine that, and it would be great to try and achieve it.

Mr. SCHWEIKERT. Mr. Katz?

Mr. KATZ. Congressman, actually, unlike my brethren on this panel who have to work for a living, I am retired, so I actually have the freedom to think about some of these issues. And in the last 5 years—I actually do a fair amount of work for the World Bank and the IMF as a so-called technical adviser, which means I am working with people who are starting from a clean slate in many respects.

Just two or three points that I think go toward this direction. The first one is what Harvey just mentioned about the regulatory philosophy. There is prudential regulation and there is business conduct regulation sales practices. The SEC has historically been pretty good at business conduct sales practices. As a prudential regulator doing examinations, it has never had the resources and it has never really done it very well. I think working on a clean slate—maybe the time is now to look at what is referred to internationally as the "twin peaks" model, separating out these two functions, point number one.

Point number two, and I know this has been said, but it just has to be emphasized. We are the only country in the world, I think, that has a separate futures regulator and securities regulator, and I believe firmly that it is an enormous impediment to our capital market development and competition. It is a huge problem to the industry, not just the regulators.

Another principle along the same lines is the heart, the core, of SEC regulation is corporate disclosure. It is founded on the basis of concept of materiality. And our system now has just become so bogged down in trivia, and it is still a paper-based system 25 years after the development of EDGAR. We need to fundamentally change our disclosure system, get away from something built upon pieces of paper put in the mail every 90 days, and get away from prescriptive trivial requirements for all companies and get back to the original concept of, tell us what is material about your company for your shareholders.

Mr. SCHWEIKERT. I appreciate it. You have actually hit on two of my favorite fixations.

Mr. CRIMMINS. Thank you, Mr. Chairman, and Congressman. Ten years ago, around the year 2000, the British decided that they were going to have a comprehensive regulator called the FSA. It was going to cover banking, securities, insurance, everything. Ten years down the road, how are they doing? They are breaking it up. It was a big organization. There may have been management problems—I am not familiar enough with it—in creating something that big and that comprehensive. There were obviously political issues, obviously the financial crisis. Can we create something that gigantic and make it actually work where we have that experiment of failure? Who knows, but—I am sorry?

Mr. SCHWEIKERT. Mr. Crimmins, I want to sort of redefine the question. It was less about creating a superregulator.

Mr. CRIMMINS. Right.

Mr. SCHWEIKERT. It was, what would accomplish the goal of maximum of capital formation and velocity of wealth distributed throughout the country and keep those investors safe, and just conceptually what would that be?

Mr. CRIMMINS. Right. No, I think that is true. If we could ever create a comprehensive regulator and make it work, or even focusing it on securities or what we can in the turf world that Congressman Frank referred to earlier, whatever we can do, even if it is just securities, I think we can make changes. And I think the risk is to try to do it all at once and just create a new agency from scratch. I don't think that is viable.

But that said, I think we can morph the existing organizations in positive ways that effectively would achieve that over time. And what I am talking about are core focuses on core missions, capital formation first and foremost. As Mr. Katz said a moment ago, when you look at the reporting requirements, some of them are excellent, and some of them are just a waste. As far as capital formation, the procedures could be simplified and streamlined, without question. Capital formation, get it right, get it simple, get it protecting investors so there is full disclosure, but make it so that small businesses can raise capital. Capital formation, market surveillance with all this crazy stuff going on, this huge shoot-up in volume, computerized trading complex products, we have to be able to look at it in real time.

Congressman, last year when we had the flash crash, they tried to deconstruct a few hours; and working on their old computers and old software, it took them 3 months just to decode what actually had happened in 3 hours. There are packages, software packages that Wall Street uses, that are able to tell them in real time what is going on. We need to get those to the SEC, and we need to enhance them and then link them, link them with other regulators, with the SROs, with the exchanges, so that in a market regulation, market surveillance issue, we see what is happening in real time in the markets. If there is a manipulation going on, stop it now before the traders get fleeced. And likewise when we do our rulemaking in the market, trading in markets area, we see what is actually happening in the markets, and our rules respond to that and not to what we imagine theoretically might be happening. So, efficient capital formation, real-time market surveillance, computer-based, technology-based real-time surveillance, and then lastly, Mr. Chairman, the enforcement tools, enforcement, beefing up enforcement with tools they need, tools to deal with the cross-border world we live in now where frauds are often perpetrated against Americans by entities offshore.

The surveillance tools that they need and the enforcement tools they need and streamlining of their investigative and litigation processes, part of which have been done recently, nationwide service of trial subpoenas and Dodd-Frank, little technical things like that which sound picky and arcane but are really, really important to make the program run well and run efficiently. So, again, core missions, focus on what makes sense, I think go through the organization, but morphing over time with buy-in from all constituencies, I think we could really get there.

Mr. SCHWEIKERT. Thanks, Mr. Crimmins.

Mr. ATKINS. Could I add just a couple of points?

Mr. SCHWEIKERT. Mr. Atkins, you are going to be next. And then, we are going to bounce back, because I want to do a little more follow-up on the capital formation, and then there is only one other question. Mr. Atkins?

Mr. ATKINS. I think one thing we can't forget is that Dodd-Frank has really changed a lot of the situation. I think it is a calamity, frankly, for the marketplace. The costs, the uncertainty that is weighing down on the economy, with regulators struggling to implement it in these unrealistic time limits that the statute sets vague directions to them; the huge missed opportunity, like Chairman Pitt was saying, to actually reorganize our broken financial services regulatory structure, and the SEC/CFTC thing is just one aspect of that.

The constitution of this Financial Stability Oversight Council we are ascribing to bureaucrats sitting around a table that they can somehow peer into the future and predict the bubbles and prick them before they happen, because ultimately it is always one person's bubble is another person's livelihood. And that was the problem with the housing crisis and everything else that went on in the build-up there in the 2000s. We have SROs who no longer really are self-regulatory organizations. They have lost the "S", they are now really regulatory organizations. So that has changed things significantly.

And to the point of trying to beef up the SEC so that it somehow will be able to monitor things closely and in real time, I think maybe that is a good aspiration in the future, but we have to realize, is that the best thing for the government to replicate things that are already in the marketplace? The SEC has subpoena power, it has ability to—and it should be working very closely with market participants to get this information should the government have that separately. And other ways, on national security issues and things like that, we don't do everything always in the government realm. There is a lot of working together with people in the private sector as well, to make sure that things are kept up-to-date and, most importantly, that the expertise, which is always hard to get and very costly, that the government can tap into that when it needs it.

Mr. SCHWEIKERT. Mr. Atkins, starting with your side, sort of bouncing back to something you actually touched on in your, I think, opening statement, and I would like to run this through the whole panel. If you were to call out one or two functions or actual activities the regulator engages in that slows down, is a barrier to smaller organizations gaining capital, gaining economic growth, producing jobs which we are all fixated on here, what is that activity and, as a policymaker, how would you change it?

Mr. ATKINS. I think the major one, frankly, is the threat of litigation. Now, we all know that it is important to have people out there, and the private securities litigation aspect in the United States is important because the government can't be everywhere, and you have to rely to a certain extent on people out there to police the markets. But on the other hand, in the United States, I think it is hard to find anybody who would say that we don't have a surfeit of these sorts of deleterious actions that, just through the threat, inhibits capital formation in the marketplace. So that, and then plus the red tape that is added through unnecessary filings and having to hire lawyers and other things, the costs in the marketplace, because of the threat of private litigation has increased for all sorts of market participants.

Mr. SCHWEIKERT. Thank you, Mr. Atkins. Mr. Crimmins?

Mr. CRIMMINS. Congressman, as the President said in the joint session last week, we have to cut the red tape, enable small businesses to raise capital and promote growth and create jobs, the problem is, Congressman, that we are putting Band-Aids on a system that was created in the 1930s for capital raising. We have a 1933 Act providing for the registration of securities and marketing of securities that is a typewriter-era, telegraph-and-telephone type of world that has been created.

We have exemptions from registration, obviously, and we can talk about those and rulemaking that the SEC could do, but I think you hit on it a little earlier when you said we are in an Internet world. We are in a really different world right now where we communicate differently, and there are ways to check on things and check on the validity of things that didn't exist before.

I would suggest that we at least consider, and I don't presume to be an expert on this, but those who are, at least consider whether we could create in the whole capital formation area an entirely electronic platform where people, small businesses could access it cheaply with some advisers, but nowhere near the crazy costs that they have now to raise capital. An electronic platform where the information could be available to everybody, it could be widely disseminated, but also where there could be electronic verification where outside professionals, whether it is financial or lawyers or accountants or whatever, could likewise contribute electronically to the filing, so you would have that immediate verification of kind of real-time electronic reporting. Just an entirely different way of thinking of things.

I think rather than putting Band-Aids on our 1933 system, which we have right now—and that is what we are doing, we are putting Band-Aids on a 1933 system. It is like repairing a 1933 car. I would suggest it is a very, very different era that we live in now, the electronic world; that those who are experts in this area tell us how we can create an electronic platform that will be safe and secure for investors but that will also let the small businesses, the little start-up companies, raise capital cheaply.

Mr. SCHWEIKERT. Thank you, Mr. Crimmins. Mr. Katz?

Mr. KATZ. I have a slightly contrarian perspective on this. Again, over my years at the Commission, the Commission has tried on numerous occasions to create sort of so-called small markets, and they have never really worked that well. At some point, I sort of came to the sad conclusion that an IPO was not always the best way for a small company to raise the cash that it needs. And right now, given the problems in the banking industry, people are saying, maybe the IPO is the answer. And I keep thinking at various times, there have been these concepts of promoting venture capitalists, promoting business development companies, and I would suggest to you that—

Mr. SCHWEIKERT. To that point, would that be raising the number of shareholders you can have before you have to—

Mr. KATZ. That becomes a piece of it. My problem with the 500 shareholder rule, frankly, is I hate on-off switch regulation, and I keep looking for gradations so that it doesn't become such a dramatic shift from one to the other. And if there was some way to develop some sort of model where you had business development companies or some variation of that playing like lead shareholder or lead investor roles, with some potential for other investors to participate, that was an interim step before you become a fully listed company. Intellectually, it seems to me, something in the middle like that may be an interesting avenue.

Mr. SCHWEIKERT. Okay, thank you. Mr. Pitt?

Mr. PITT. Yes, I think we have a couple of problems. The first is, as has been mentioned, we are dealing with an antiquated set of foundational statutes, and most of the innovations over time—and it is not just for the SEC, it is in the banking area as well—have been by jury-rigging existing statutes to sort of get around some of the restraints.

There is not enough attention paid to the fact that government is a service business, and when people have new ideas and they want to get to market and they have ideas, if they run into the kinds of bureaucracy and red tape that they do, they can't get their ideas to market.

So when I was in private practice, I saw people's money dry up when the staff couldn't get to those issues because they had other issues, and they didn't know how to juggle their efforts. And so one problem is clearly the fact that the statutes are antiquated.

Second, we have a system that is predicated now on reverse logic. If you look at what the most sophisticated investors want when they choose to invest their capital, they want current and future information. They are smart enough to know that if you give them projections and so on, they are going to have to discount some of that, but what they want is what is available now and what you are anticipating a year from now and back it up. What we give the public is retrospective information. So all the public gets is what has already happened. There is this huge disconnect.

And I think the issues that arose with Facebook and Goldman Sachs point out exactly why our system is so bad. You had a company that was extremely valuable, and it thought it could raise $50 billion, an unheard of amount for an IPO, without going through the SEC process, all because that process takes forever, it induces litigation, as Commissioner Atkins said, it requires red tape to get through the SEC and get your documents out, and it gives investors the most meaningless of disclosure; namely, what happened last year instead of what is happening today and tomorrow.

Mr. SCHWEIKERT. That is actually helpful conceptually. And because I am out of time, the Chair is going to yield himself another, what do you think, 6 hours? Professor?

Mr. VERRET. Yes, I think on this point, I am largely in agreement with the rest of the panel, and I think—

Mr. SCHWEIKERT. Forgive me, Professor, did you say "unfortunately" or "fortunately?"

Mr. VERRET. Fortunately, yes. I am in agreement with the panel I think on this, and I am particularly excited about the prospect of some of the bills that have been introduced on crowdfunding and reform of Reg A. And I would pay attention to, I think, what has been an unfortunate eventuality in most of the exemptions or reform of rules at the Commission, which is that an exemption is established and either at the beginning or as it is interpreted, it is eroded away. Either at the very beginning, an exemption is created, but to make use of the exemption you have to, for instance, in a number of regs, you have to issue reports that are maybe not audited but still have the same substance as the 10-Q or 10-K.

In other words, I think we create exemptions sometimes in securities laws that aren't really exemptions at all. And also in part, I think this issue goes to erosion of the exemption through litigation by the agency, and I think part of that goes to the heart of the lawyer dominance of the agency. Lawyers have a vital role to play at the SEC, and lawyers are always going to be maybe at the head of the table, but I think economists should be part of the conversation.

Mr. SCHWEIKERT. Professor, you had to break my heart there, didn't you?

Mr. VERRET. Yes, right. But I think economists need to be part of the conversation, and I think we can learn a lot from the FTC in this. The FTC has a very analogous, in many way analogous mission: protect consumers versus investor protection. Different types of law that are enforced by those agencies, but in many ways analogous. We look at the FTC: 1,000 employees, almost 100 of whom are economists. At the SEC: 3,700 employees, about 30 of them, counting very liberally, are economists, right? Ten percent at the FTC versus about 1 percent at the SEC. I think that is a big—that is indicative of a problem.

Mr. SCHWEIKERT. Gentlemen, why don't we call it quits. I want to thank you for spending this time with us. You actually all are grazing an issue that I think is going to be really important, because it is one of those few occasions where I think both on the right and the left we have a common agreement that is emerging, whether it be the Reg A, whether it be some of the discussions about the cloud funding. And with the use of the Internet, does that create better public exposure, faster timing, a more current look, and is that sort of a more honorable future for the regulatory body but also much more cost-effective? And our great hopes as we start to move into some of these more current discussions of capital formation, does that also provide us an opportunity to go to the next generation of regulatory?

So if any of you ever come across articles or something you think we should read, please, send it to us. It is time we get our heads around this.

The Chair notes that some Members may have additional questions for these witnesses that they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit questions to these witnesse and to place their responses in the record.

With that, the hearing is adjourned.

[Whereupon, at 3:10 p.m., the hearing was adjourned.]

A P P E N D I X

September 15, 2011

American Enterprise Institute
for Public Policy Research

Statement before the United States House of Representatives
Committee on Financial Services
On Fixing the Watchdog: Legislative Proposals to Improve and Enhance the SEC

Statement of Paul S. Atkins

The Honorable Paul S. Atkins

Visiting Scholar

American Enterprise Institute

September 15, 2011

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

STATEMENT OF PAUL S. ATKINS
BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
HEARING ON "FIXING THE WATCHDOG: LEGISLATIVE PROPOSALS TO IMPROVE AND ENHANCE THE SEC"
SEPTEMBER 15, 2011

Thank you very much, Mr. Chairman, Ranking Member Frank, and Members of the Committee, for inviting me to appear today at your hearing. It is an honor and privilege for me to provide information for your deliberations regarding organizational issues at the Securities and Exchange Commission.

I come before you today as a visiting scholar at the American Enterprise Institute for Public Policy Research, as well as a former commissioner of the Securities and Exchange Commission and a former member of the Congressional Oversight Panel for the TARP.

I would like to begin by congratulating this Committee for taking up the issue of improving and enhancing the SEC. I have had the privilege of working at the SEC a total of ten years, first as a staffer in two chairmen's offices and then as a commissioner under three chairmen. In that time the SEC has grown from an agency of approximately $170 million to the current budget of more than $1 billion.

REORGANIZATION OF THE SEC

Because the public sector lacks the crucible of competition to winnow out inefficiencies and promote better management systems, it is periodically necessary for Congress and the president to step in to do so. A good example of this was the approach that the Congress and several administrations undertook from the end of the 1930s in various steps to try to reorganize the federal bureaucracy. Of course, by the end of the 1930s they had to do something because of the creation and huge growth of the alphabet soup of agencies under President Franklin Roosevelt. A rationalization was necessary. In the SEC's case, it became clear by 1950 that the consensus-driven management of the agency by the five commissioners was no longer efficient – the size of the agency required that there be a leader who would run the business aspects of the agency, versus the policy aspects, which were to remain the domain of the five-person bipartisan commission. So, Reorganization Plan Number 10 of 1950[1] was formulated. It in effect increased the power of the SEC chairman: the chairman would have clear authority over hiring and supervision of staff (except for the appointment of the heads of the major offices, who would be approved by the commissioners), the budget, and allocating responsibilities among the staff.

Thus, in about one page, the management of the SEC – and the relationship of the chairman to the other commissioners – was drastically changed. The staff, therefore, should know who the boss is. Other agencies have a similar organization, including the Federal Reserve, the CFTC, and the FTC. That sort of management organization gives certainty and also accountability. No one can hide behind a "committee" or "commission" – the buck stops with the chairman, as it should. In a greater sense, at the SEC the buck stops with the president, since the president at the stroke of a pen in an executive order can designate at will any other sitting commissioner as chairman.

The Dodd-Frank Act. In contrast to Reorganization Plan 10, last year the Dodd-Frank Act was enacted. In its 2,319 pages, Dodd-Frank attempted to address many things. Simply put, that is its problem – it addressed too many things not very well. As to the SEC, it haphazardly touched on certain organizational and managerial issues, seemingly as an afterthought and not part of any articulated, integrated plan. It became a grab-bag of ideas that through micro-management has made management of the SEC more difficult.

For example, Dodd-Frank added four statutorily mandated, direct reports to the chairman: the Investor Advocate, the Office of Minority and Women Affairs, the Office of Credit Ratings, and the Office of Municipal Securities. Because these provisions are statutory, the chairman has little alternative to do things differently, especially since the chairman already has more direct reports than is practicable. These provisions depart from the less-prescriptive approach of Reorganization Plan 10, which allows the chairman to allocate responsibilities among the staff.

[1] Reorganization Plan No. 10 of 1950, 15 F.R. 3175, 64 Stat. 1265 (found at 15 U.S.C. § 78d note).

Similarly, Section 911 codifies the Investor Advisory Committee that the current chairman established, which itself was similar to the Consumer Affairs Advisory Committee that I helped Chairman Levitt establish when I worked in his office in the mid-1990s. Chairman Levitt's committee replaced a couple of advisory committees that Chairman Breeden had established, which focused on emerging markets and market structure issues. So, this statutory provision etches in stone one way of doing things to the exclusion of others. It even prescribes how the members of the committee should be chosen. In addition, the Investor Advocate, an independent office established under Section 915, is statutorily empowered to hire his own attorneys, accountants, and consultants and to make independent reports to Congress, with no review by the chairman or the commission. The joke at the SEC these days is that the budget will have to be built around the Investor Advocate – the chairman will have to find out what the Investor Advocate determines that his office needs, and then the rest of the agency can make its plans within the resources set by Congress. Again, these provisions are departures from the approach of Reorganization Plan 10.

In the process of this micro-management, the intent of the statute's authors will not even be achieved. For example, Section 965 of Dodd-Frank, including its history, clearly sets forth the proposition that Congress intended that the examiners of the Office of Compliance Inspections and Examinations (OCIE) be transferred to the Divisions of Trading and Markets and Investment Management. The hoped-for synergies that partly drove the creation of OCIE in 1995 clearly were not achieved, as demonstrated most notably by the Madoff and Stanford failures. The SEC chairman, however, apparently has decided to leave the general organization of the examination office in place, but consider Dodd-Frank Section 965 satisfied by housing the credit-rating agency examiners in the Division of Trading and Markets and adding a few examiners to the Division of Investment Management to act as liaisons with OCIE.

Current SEC Management. Recently the SEC has had its share of management issues. Congress recognized the problem in Dodd-Frank under Section 967 to require that the SEC commission an independent review of its management and organization. Unfortunately, this review does not appear to be independent and was not very well done. In the process, the SEC spent almost $5 million on the consultants to produce the report. I understand that Jack Katz will address specific components of the report.

Other aspects of the report's recommendations demonstrate how even recent organizational changes were not well thought through. For example, the chairman created a new position of chief operating officer in early 2010, which took on some, but not all, of the functions of the existing executive director's position, which resulted in an artificial division of back-office functions. The BCG report recommended combining the positions, which the chairman did. To her credit, she reversed her earlier decision. The resulting "chief operating officer" is basically just a new title for the former executive director position, and is still not a "chief operating officer" as such a position is normally understood to be, since it is responsible only for back-office functions.

POTENTIAL LEGISLATIVE REFORM

SEC Modernization Act of 2011. I commend this Committee for taking a fresh, deliberate look at the organizational structure of the SEC with the draft legislation under discussion today. I also commend Chairman Bachus for proceeding in regular order – holding legislative hearings to gather commentary and consider openly the best approach before introduction of actual legislation.

The Committee correctly perceives that the SEC desperately needs organizational change to increase efficiency and to improve its regulation of the markets that it is tasked with regulating, considering how dramatically the markets have evolved. With that said, I would caution against being too prescriptive regarding the internal organization of the SEC. Times and circumstances change, and the example of Reorganization Plan 10 demonstrates that general guidelines may be sufficient. Much depends on good managerial experience to lead the agency, which of course cannot be legislated.

The draft bill contains many good ideas. Perhaps most importantly, the draft bill recognizes that economists have been second-class citizens too long at the SEC. The SEC historically has been an agency of, by, and for lawyers. Does this make sense for an agency that is charged with overseeing and regulating the largest capital markets in the world and promoting efficiency and capital formation? The current chairman's reorganization of the chief economist's office in effect demoted the economists' function – they reported to a lawyer rather than an economist. Many economists left as a result. The endemic problem is that economic analysis at the SEC has been performed as a post hoc exercise: the policy for rulemaking is mostly determined first by the lawyers and only near the end of the process are the economists brought in to justify the actions on a cost-benefit basis. A recent example is the case *Business Roundtable and Chamber of Commerce v. SEC,* which the SEC lost in the D.C. Circuit. In that case, the SEC failed to perform adequate economic analysis. The draft bill envisions the restoration of economists to their proper role as advisors to the Commission.

However, the draft bill suffers in part from the same prescriptive tendencies of Dodd-Frank. I understand the necessity to correct the Dodd-Frank deficiencies, but the most direct approach would be to repeal Dodd-Frank, or at least its most problematic provisions. Thus, I would encourage this Committee to address the specifics of Dodd-Frank and leave other organizational aspects at a general level and to the SEC chairman's discretion.

Among the issues raised or created by Dodd-Frank that need to be addressed are the examination function, the many new positions reporting to the chairman, the Investor Advocate, and the Investor Advisory Committee. For example, Congress correctly is frustrated at the management and results of the SEC's examination function. Unfortunately, the structure of the Office of Compliance Inspections and Examinations (OCIE) was never addressed during the last few years. The restructuring of OCIE gained substantial support while I was on the Commission, even though the question never came to a vote. The current director, having taken over from a director who served since the office's creation in 1995 – almost 15 years – has tried to make organizational and operational changes. But, the best reorganization at this point would be to put the examiners closer to the staff who are considering and formulating regulations, and vice versa.

Dodd-Frank clearly directed the SEC to make this organizational change. The current work-around of this congressional direction – keeping OCIE, but putting examiner liaisons in the

Division of Investment Management – actually makes the examination function at the SEC, especially on the investment adviser and investment company side, less coherent and potentially conflicting. It certainly does not change the status quo, which has been shown to be fatally flawed in a way that all the world could see and, most importantly, devastated so many innocent investors to the tune of billions of dollars.

Thus, making the change to OCIE is important. I submit it can be done using the approach of Reorganization Plan 10 – specifying that it is the sense of Congress that the examiners and the rule-writers be as close as possible in the organizational framework.

The draft bill does not go far enough with respect to the other Dodd-Frank-mandated direct reports to the chairman – they should be eliminated, because each function already can be performed in existing units at the SEC. In particular, with respect to the Investor Advocate, the SEC itself is the investor's advocate. If Congress does not like the work of the agency, or think that it is lacking, it can influence that work and priorities through hearings and other communications with the chairman. An anomalous staff position that seeds the agency with potential conflicts only makes management more difficult and will distract from the business of the agency.

In other respects, the draft bill would retain some dated aspects of the SEC's organization. For example, Chairman Breeden established the Office of International Affairs as a central point of contact for international matters when the Iron Curtain fell and the SEC began to establish relationships and negotiate memoranda of understanding with many nations forming new capital markets. Twenty years later, international matters are integral to almost every aspect of policy in the various offices and divisions. Rather than Congress mandating this particular structure, perhaps a chairman may wish to reallocate responsibilities among the various divisions and offices.

While I acknowledge that Congress must act, Congress should be careful in prescribing a detailed statutory reorganization of the Commission. Congress's role should be to provide guidance to the SEC without binding it by statute. Because statutes are inflexible and difficult to change, a statutory reorganization of the SEC would prevent the SEC from evolving with the marketplace in the future. With its hands-off approach that encourages accountability in a chairman, Reorganization Plan No. 10 is a good model for future legislation.

The SEC Regulatory Accountability Act. As I mentioned earlier, the SEC has for years failed to incorporate true economic analysis into its rulemaking process, especially in a way to help direct and prioritize rulemaking. For example, with respect to the proxy access rules recently struck down by the U.S. Court of Appeals for the D.C. Circuit, the court found that the SEC failed to provide meaningful economic analysis. The stinging opinion, written by Judge Ginsburg, reproaches the SEC for failing to provide sufficient data to support its legal conclusion that proxy access rules would improve board performance, and for failing to adequately assess the economic effects of the rules. This is indicative of the general rulemaking procedure at the agency.

For that reason, I submit that Chairman Garrett's proposed SEC Regulatory Accountability Act contains many good ideas. This bill directs the SEC to utilize economists to decide whether or not to propose or adopt a regulation—and to do so only after considering the costs and benefits. Regulation may be indicated when there is a market failure, but the key is determining whether there is a market failure and how best to approach it. Otherwise, unintended consequences may result. These sorts of determinations should be the motivating force behind rules; lawyers generally are ill-equipped to make such determinations. Input is necessary from economic, market, and product experts to craft effective regulation.

Modifying the Sunshine Act. Currently, the Sunshine Act engenders the unintended consequences of inhibiting collegiality and policy development between commissioners. Even informal gatherings of a quorum of commissioners are difficult to arrange. The result is that the commissioners must rely on the staff more than direct contact. Amending the Sunshine Act to allow informal gatherings, even to discuss policy matters, as long as a rulemaking is not discussed, would increase the efficiency of commission work. Sufficient protections, however, must be put in place so that the letter and spirit of the Administrative Procedure Act and the Sunshine Act are maintained.

Merger of the SEC and CFTC. Arcane vagaries of regulation exist in the space shared by the SEC and CFTC on futures and derivative instruments. For example, a security futures product (SFP) is both a futures contract and a security. Entities effecting SFP transactions must be registered both with the CFTC as futures commission merchants and with the SEC as broker-dealers. Even more arcane are the statutory provisions that divide securities and futures products. For example, futures on "narrow-based" securities indices, which are products with nine or fewer component securities, are jointly regulated by the SEC and CFTC. Futures on "broad-based" securities indices—or futures on indices with ten or more component securities with a certain weighting—are under the exclusive jurisdiction of the CFTC. That is a division that arises more from bureaucratic turf conflicts than from sound regulatory (or common sense) policy.

Merging the SEC and CFTC and creating a new agency with seven Commissioners would save money and reduce bureaucracy, owing to the scheme's fewer Commissioners and a reorganized staff. It could also solve some of the unintended consequences of the Sunshine Act. With more commissioners, larger numbers could meet to discuss issues. The agency chairman could even take an approach that the Federal Reserve takes and designate a commissioner or two (even one from each party) to look over various agency functions. More interaction among the commissioners could even make the commission less politicized.

Of course, if this merger is to be effected, it should be done with care. The statutes and rules governing the securities and futures markets are different, and the approaches that the two agencies take are different. The futures markets are mostly dealer markets, while the securities markets have a large retail investor component. A merger cannot simply be the combining of two agencies under one roof; it would be a complicated task.

The Investment Adviser Oversight Act of 2011. Another area of potential reform required by Dodd Frank is the SEC's oversight and reliance on self-regulatory organizations (SRO), most notably FINRA, and the possible delegation of investment adviser oversight to an SRO. This Committee held a hearing two days ago regarding this issue. The BCG study addressed the

SEC's interactions with SROs in broad terms, and made a few recommendations: strengthen oversight of SROs through enhanced disclosures about regulatory activities, improved metrics and standards to measure performance, and enhanced oversight of FINRA; centralize and coordinate the agency's interactions with SROs; and strengthen the processes for reviewing SRO rule proposals. As discussed in Tuesday's hearing, these gaps in SEC oversight should certainly be corrected, and I hope the next SEC report will be able to mark progress beyond "outreach and collaboration opportunities."

Unfortunately, this discussion ignores the more glaring problems of what FINRA has become. Today's FINRA has departed from the worthwhile goals of self-regulation envisaged in the 1930s; namely, the balance of efficient and effective regulation with the need to be accountable and transparent. Its budget has reached $887 million – not far from that of the SEC itself – while compensation for its top ten executives exceeded $11 million in 2009. FINRA has a virtual monopoly on oversight of broker-dealers. And while most of the blame over the Madoff and Stanford schemes has been placed on the SEC, both firms were registered with and examined by FINRA for years.

Perhaps most concerning is the lack of transparency. While FINRA and other SROs can enact rulemakings that carry the force of law, they are not subject to the Administrative Procedures Act, Freedom of Information Act requests, and are not required to conduct any cost-benefit analyses. The disciplinary process raises due process concerns. Its board meetings are private and not subject to the Sunshine Act, of course. This lack of transparency and accountability to either the SEC, its members, or the public is a real concern underlying the present discussion over delegating authority to oversee investment advisers. The question of whether FINRA is a state actor is another issue that sooner or later will be raised in Congress or in the courts, as it has already been raised in at least one case concerning the invocation of the Fifth Amendment when the defendant was a registered person being investigated by FINRA as well as by the SEC and the Department of Justice.

Although the subject of an SRO for advisors is not necessarily the subject of this hearing, I must raise serious concerns regarding expanding FINRA's empire without a fundamental re-evaluation of its statutory functions and organization.

GENERAL MANAGEMENT APPROACH OF THE SEC

Management philosophies like Total Quality Management and Six Sigma teach that in any organization, measurement drives human behavior because the incentive is to try to meet the measurement criteria ("You get what you measure").

For example, Enron SEC filings were not reviewed for years because review personnel were judged by how many filings they reviewed, not necessarily by the quality of their review. The incentive was to postpone review of the complicated Enron filing because one could review many others in the time it would take to review Enron. By the late 1990s, this focus on numbers more than quality had decreased staff morale so much that employees began to organize to form a union. Despite management's campaign to thwart it, in July 2000, SEC employees voted overwhelmingly to unionize the workforce.

The emphasis on numbers over quality also affects behavior in the enforcement division and examination office. Every enforcement attorney knows that statistics (or "stats") help to determine perception and promotion potential. The statistics sought are cases either brought and settled or litigated to a successful conclusion, and amount of fines collected. These statistics do not necessarily measure quality (such as an investigation performed well and efficiently, but the evidence ultimately adduced did not indicate a securities violation). Thus, the stats system does not encourage sensitivity to due process.

In addition, the stats system tends to discourage the pursuit of penny stock manipulations and Ponzi schemes, which ravage mostly retail investors. These frauds generally take a long time and much effort to prove – the perpetrators tend to be true criminals who use every effort to fight, rather than the typical white-collar corporate violator of a relatively minor corporate reporting requirement who has an incentive to negotiate a settlement to put the matter behind him and preserve his reputation and career. Thus, over the years several staff attorneys have told me that their superiors "actively discourage" them from pursuing Ponzi schemes and stock manipulations, because of the difficulty in bringing the case to a successful conclusion and the lack of publicity in the press when these cases are brought (with the exception of Madoff, these sorts of cases tend to be small). Some senior enforcement officers openly refer to these sorts of cases as "slip-and-fall" cases, which disparages the real effect that these cases have on individuals, who can lose their life savings in them. Because of the interstate and international aspect of many of these cases, if the SEC does not go after them, no one can or will. Not to discount the importance of combating any fraud, we need to remember that one individual losing his entire life's savings is extremely serious, even if it is "only" five digits in size.

During my tenure as commissioner, I advocated the need for the enforcement division not to minimize the importance of fighting microcap fraud, including Ponzi schemes, pump-and-dump schemes, and other stock manipulations. I was a strong advocate for the formation of the Microcap Fraud Group in the Enforcement Division, which was finally formed in 2008. I had also strongly supported the good efforts of the Office of Internet Enforcement, established under Chairman Levitt in the late 1990s, which worked closely with other law enforcement agencies to tackle internet and other electronic fraud. Unfortunately, it appears that while the administrative overhead functions within enforcement are gaining resources, insufficient attention is being paid to "boots-on-the-ground" investigative resources to combat the pernicious frauds that prey on individual investors.

Three years ago, in an article published in the Fordham Journal of Corporate and Financial Law[2], I called for the SEC to follow the example from 1972 of Chairman William Casey, who formed a committee to review the enforcement division – its strategy, priorities, organization, management, and due-process protections. Almost forty years later, and especially after the Madoff incident, this sort of review is long overdue.

---

[2] *See* Paul S. Atkins and Bradley J. Bondi, "Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program," 8 Fordham Journal of Corp. & Fin. Law 367 (2008).

CONCLUSION

There are many intelligent, competent, dedicated, hard-working people at the SEC. It is the management system and how it determined priorities over the past decade that has let them down. The system essentially is unchanged today. I salute this Committee for taking on this issue and continuing a public discussion. It is far from a problem that is easily addressed by money or creating new offices, as Dodd-Frank has done. In the past decade, the SEC's budget has increased threefold and the fundamental problems remain. For the sake of investors, who have lost billions in fraudulent schemes that should have been discovered, it is high time that these organizational issues be addressed.

Thank you again for the invitation to come here and testify before you today.

House of Representatives Committee on Financial Services

"Fixing the Watchdog: Legislative Proposals to Improve and Enhance the Securities and Exchange Commission"
Thursday, September 15, 2011, 10 am
2128 Rayburn House Office Building

Testimony of Stephen J. Crimmins

(Mr. Crimmins is the chairman of the DC Bar's Committee on Broker-Dealer Regulation and SEC Enforcement, the chairman of the Federal Bar Association's Securities Law Section and Executive Council, a partner in the K&L Gates LLP law firm, and formerly (until 2001) a senior officer of the SEC's Enforcement Division.)

What We Knew When We Doubled the SEC Budget

By last summer, most of the criticisms that are now being thrown at the SEC were already out on the table. All of us had long before heard about the Madoff tragedy. Madoff, who FINRA's predecessor organization had installed as its own Chairman. Madoff, who the securities industry put on the board of its leading trade group. Madoff, the industry icon and idol who the SEC, FINRA, the New York attorney general, and the firms that dealt with him on a daily basis all failed to realize was really a crook.

It was yesterday's news to us last summer that some SEC employees, like other public and private sector employees, viewed Internet porn on company time. And it was yesterday's news that the SEC lacked the private-sector business corporation's bookkeeping systems and controls that GSA would have liked. So did other federal agencies.

But we also knew that, year after year, through thick and thin, the SEC's hard-working staff filed almost 700 complex securities cases against almost 2,000 defendants. A figure no private sector law firm of similar size to the SEC could ever dream of matching. And we also heard how the SEC has a very full plate. Just 3,700 employees (counting everyone from Chairman to support staff) examining 11,000 investment advisers, 5,000 broker-dealers with over 160,000 branch offices, and 7,500 mutual funds. Reviewing tens of thousands of disclosure documents each year. Plus riding herd over 500 transfer agents, 15 securities exchanges, 10 ratings agencies, 9 clearing agencies, and for good measure the Public Company Accounting Oversight Board, a collection of SROs, and a market trading over 8.5 billion shares a day.

So having already heard most of the same criticisms we're hearing today, but considering the SEC's thousands of successful cases and other activities over just the last five years, and finding itself in the midst of the worst financial crisis in 80 years, what did Congress decide to do? Congress last summer enacted legislation to double the SEC's budget in specified steps over five years. Importantly, in doubling the SEC's budget, Congress knew that it was not spending a dime of taxpayers' money and not having any deficit impact. This is because since bipartisan legislation in 1996 the SEC has always been run entirely on uncontroversial Wall Street user fees and never on tax dollars.

Why did Congress decide to double the SEC's budget last summer? That's easy. Because Congress knew that to get the jobs Americans need, there has to be growth. And to have growth, there needs to be capital formation. And to have capital formation, we need clean markets where investors – large and small – are willing to risk their capital. And this – giving us clean, orderly and well functioning markets – is exactly what the SEC does for a living. After running the SEC on a shoestring for decades, Congress wisely realized that, to get out of the worst downturn since the 1930s, we needed a securities market overseer that had the resources to make a difference.

The Cost of a Wall-to-Wall Reorganization: Institutional Paralysis

Twelve months later, none of this has changed. We still know pretty much what we knew last summer. But are we actually appropriating the doubled SEC budget – paid with Wall Street user fees – that Congress saw as necessary and promised just last summer? No. Instead we're hearing from well-meaning but high-priced management consultants about things like "optimization initiatives"; "time-phased multi-year implementations"; "cross-work-stream integration points"; and an "executive data governance council" to develop "optimized enterprise data architecture." What has this got to do with the active capital formation, efficient trading markets, and fraud detection we need so desperately today? Sadly, we're also hearing about "no regrets" optimization, SEC staff RIFs, closing unspecified numbers of SEC regional offices, and staff demotions – all just great for morale and effectiveness just when we most need the SEC to help us restore our nation's economic growth.

We're forgetting that a wall-to-wall restructuring will effectively paralyze the SEC for a year, two years or longer. Meetings held to plan and re-plan new reporting chains, and reallocations of power and authority among offices. Drafting new job descriptions to match new job titles and structures. Staff members reworking and burnishing their resumes, and spending days pondering how best to handle the internal job interview process. And petty office politics and rivalries playing a much bigger role that the consultants' "no regrets" optimization.

What will happen to the work left unattended during this process – the work of ensuring clean markets and encouraging capital formation, the work of policing the markets to attract investors large and small to put their capital at risk? Will that work become a part-time job while staff cope with massive reorganization? Instead, with our economy in crisis and business activity cycling downward, we should put the org charts and the consultant-speak on the shelf for the time being. We can do those things later when we're sailing on calmer seas.

SEC Modernization Act

Let me turn to the proposed SEC Modernization Act. While it would be a mistake to waste a year, two years or more lost in the dense forest of planning and executing an agency-wide reorganization reaching into every corner, it would be equally a mistake to ignore the dynamic changes taking place every day in our capital markets. New high speed computerized trading strategies, daily volume going through the roof, complex new investment products that even their creators don't always fully understand. The SEC, like all of us, needs to adapt and change with the times. The last thing we should want is to try to roll the clock back to some imagined golden age of the SEC, and then cement that era's version of the SEC in statutory stone where it could never be changed without an Act of Congress.

Yet the proposed SEC Modernization Act would do exactly that. It rolls back the clock 25 years. It pulls out the SEC's org chart from about the mid-1980s, and would decree by statute that this org chart may never be changed. Our Constitution obviously did not freeze Congress's committee structure. In recently bailing out major financial and business enterprises, Congress did not freeze their organizational structure by statute. Nor should Congress freeze the structure of the SEC, a step that would prevent the SEC from being what Congress wants – a nimble and flexible agency that can quickly "modernize" itself on an ongoing basis to meet new challenges in our markets. Even the management consultants tell us this. They specifically direct the SEC to petition Congress for "flexibility" to design the SEC's own structure to "improve operational performance" and "locate efficiencies."

Instead of endless reorganization hell – instead of just thinking about how to think about what to do – the SEC needs to get to work today on its three core missions: Encouraging capital formation. Assuring clean and efficient trading markets. And policing the markets to rout the fraudsters.

Capital Formation / Small Business

Talking about capital formation in last week's Joint Session, the President spoke for both parties in urging that we "cut away the red tape that prevents too many rapidly growing startup companies from raising capital and going public." The President saw that America's startups are often being starved of the capital they need to grow due to the cost and delay of a traditional stock offering. As a work-around, some startups try going public through so-called "reverse mergers" where they must give stock promoters a huge portion of their company's ownership to get folded into a defunct listed company the promoters control, with the promoters then dumping the stock on unsuspecting public investors with little or no disclosure beyond the promoters' own glowing press release.[1]

As the President recognized, there is a better way. The SEC can write rules to give us cheap and efficient procedures for America's small businesses to raise capital, but procedures that are still squeaky clean and that tell prospective investors what then need to know to make an informed investment decision. Perhaps a system built entirely on an electronic platform that provides for independent professional verification of key information, as well as some form of corporate monitoring during the startup company's early phase and control over any significant commitment of investor funds until investors can be sure the company is legitimate.

---

[1] Obviously not all reverse mergers are bad, and we all know that the New York Stock Exchange itself went public through a reverse merger. But in the wrong hands, reverse mergers can be toxic – bad for the original entrepreneurs and bad for investors.

SEC Regulatory Accountability Act

But we can forget about such rulemaking to streamline capital formation or anything else if we keep handing opponents of all political and ideological persuasions more and more tools to block anything the SEC tries to do. This will inevitably be the unintended consequence of the proposed SEC Regulatory Accountability Act. While well meaning, the Act would have the effect of letting any SEC rule opponent litigate in federal court over whether the SEC had appropriately assessed a laundry list of amorphous factors in any SEC rulemaking. Indeed, the Act is drafted so broadly that it could be applied even to the SEC's enforcement "orders," and not just to rulemakings. And beyond this, the Act would consume vast amounts of SEC staff time with periodic reviews of the existing substantial body of federal securities regulations to find anything deemed "outmoded, ineffective, insufficient or excessively burdensome."

Just as America's businesses need new SEC rules to streamline capital formation and traders need new SEC rules to streamline markets, so also we must give the SEC itself a streamlined process for issuing those rules. The SEC already has to include dozens of pages of detailed cost-benefit and other economic analysis every time it writes a rule, and we don't need to pile on more requirements.

Market Surveillance Technology

We also need to give the SEC the technology it needs to monitor the markets in real time. This will let the SEC spot stock manipulations in progress and shut them down before honest stock traders get fleeced. It will also let the SEC reconstruct market data to support its enforcement cases and to intelligently write trading rules that deal with what actually happens in the markets, not what people guess may possibly happen.

We need to start by immediately giving the SEC the market analysis software already used by Wall Street firms and exchanges, and the hardware to run it on. Beyond this, we need to develop more sophisticated systems and possibly link them with the other regulators and exchanges to assure comprehensive policing of our markets.

Conclusion

A back-to-basics focus on core SEC missions of capital formation, market surveillance, and antifraud enforcement is what these difficult times demand. Not micromanaging the SEC. Not paralyzing it by piling on mandated "multi-year" reorganizations, studies, and new requirements and procedures. It's time to let the SEC get to work.

Finally, we need to recognize that the SEC is an agency filled with people who could be making a lot more money – sometimes multiples of their present salaries – in the private sector. What keeps them going during the years they choose to spend at the SEC is their enthusiasm for its mission. With SEC staff morale withering under the current barrage of criticism, if we really want to retain top talent, we all need to stop using the SEC and its staff as a piñata. Last summer, with all the recent criticisms already out on the table, Congress made the sound decision to double the SEC budget – again, using Wall Street user fees that are already available and no tax dollars -- to help get us out of the present crisis and do what we can to avoid future crises. It's time to deliver on that promise.

Statement
of the
U.S. Chamber
of Commerce

ON: "Fixing the Watchdog: Legislative Proposals to Improve and Enhance the Securities and Exchange Commission"

TO: The House Committee on Financial Services

DATE: September 15, 2011

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business -- manufacturing, retailing, services, construction, wholesaling, and finance – is represented. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 115 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. More than 1,000 business people participate in this process.

Good morning, Chairman Bachus, Ranking Member Frank, and members of the Committee. It is an honor to be invited to testify at today's hearing: ***Fixing the Watchdog: Legislative Proposals to Improve and Enhance the Securities and Exchange Commission***. This is a subject that is of great importance to me personally. For 23 years I was an employee of the Securities and Exchange Commission ("Commission"). For 20 of those years I served as the Commission's Secretary. This was a position that afforded me a rare opportunity to participate first hand in virtually every aspect of the Commission's responsibilities. I considered it an honor and a privilege.

I retired from the Commission in January 2006. In the five years since my retirement I have been equally fortunate. I have had the opportunity to use the knowledge I gained at the Commission to advise government regulators in a wide array of countries. This experience has caused me to critically examine many fundamental principles of financial regulation, what it means and what it can accomplish. In addition to my international work, I have also had the opportunity to speak and write about financial regulation in the United States. In 2008, the U.S. Chamber of Commerce's Center for Capital Markets Competitiveness ("CCMC") invited me to conduct a study and write a report on how to improve the efficiency and effectiveness of the Commission. Released February 2009, that study, *Examining the Efficiency and Effectiveness of the U.S. Securities and Exchange Commission* ("the CCMC Report"), focused on the management of the Commission and three of its core responsibilities of the Commission:

1) the no-action letter process, primarily in the Division of Corporation Finance;

2) the process for reviewing self-regulatory organization rule filings in the Division of Trading and Markets; and

3) the process in the Division of Investment Management through which registered investment companies apply for and obtain exemptions from specific requirements under the Investment Company Act of 1940.

While I prepared the CCMC Report for the Chamber, I cannot take sole credit for its recommendations. The 23 recommendations, to improve the management and operations of the Commission, in the CCMC Report represent the collective ideas of more than fifty current and former Commission staff and Commissioners who agreed to be interviewed and who freely offered their ideas, insights, and criticisms. It is gratifying that, in the two years since the report was published, the Commission has implemented or begun to implement several of the recommendations. While some progress has been made, clearly transformative change at the Commission is needed for the efficient and even handed regulation needed to have competitive financial markets in a global economy.

This statement and my testimony today also are based on an article I wrote in 2009, published in the University of Pittsburgh Law Review. The article focuses primarily on the Enforcement program at the Commission, a subject that I did not discuss in the CCMC Report. While the CCMC Report is based upon a series of interviews, the enforcement article is based solely on my personal views and research. I have previously provided the Committee's staff with electronic copies of both articles. Both documents are freely available on the Web sites of the U.S. Chamber of Commerce and the University of Pittsburgh Law Review.[1]

I am currently conducting another study for the CCMC on the Commission. This study, which I hope to complete in the very near future, is examining the changes at the Commission since the last report. My goal is to provide a series of recommendations on the future direction of the Commission and what should be done to enable it to regain its status as an outstanding government agency. I hope that the upcoming report will be useful to the Committee in its ongoing efforts to oversee the SEC and to support vibrant U.S. capital markets.

Section 967 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("the Dodd-Frank Act") mandated that the Commission retain an independent management consultant to review the operations of the agency and recommend changes to improve its performance. Congress specified seven areas for the consultant to address. This Congressional directive was in direct response to a series of events during the past decade that raised legitimate questions as to the effectiveness of a government agency that for much of its history has been considered an exemplar of sound and effective government. In my opinion, it also exemplified what Congress should do when a government agency appears not to be performing effectively. Congress should ask important and tough questions and require sound and carefully considered answers.

Because of my continuing interest in the Commission, I shared the Congressional concerns embodied in §967. Having tried to examine many of the same issues myself I looked forward to seeing what an organization with the

[1] The U.S. Chamber of Commerce report is available at: http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/ExaminingtheSECrdcfinal.pdf
The Law review article is available at:
http://lawreview.law.pitt.edu/issues/71/71.3/71_3_Katz_Reviwing_the_sec.pdf

reputation and resources of Boston Consulting Group ("BCG") would learn and what it would recommend. Sadly, I was extremely disappointed with the result.

The BCG Report addresses the seven topics in a generalized and superficial manner that fails to inform, clarify, illuminate, or direct action. Its analysis and findings are largely conclusions, lacking in insight and devoid of empirical foundation. Its recommendations are so general they can't be implemented.

Rather than attempting to summarize and critique the entire BCG report I am going to focus on its discussion of Commission reorganization, as this is the subject of today's hearing. Following my comments on the BCG report, I will offer my perspective on the bills proposed by Chairman Bachus and Congressman Garrett. I will conclude with several recommendations to consider as Congress contemplates what actions to take to improve the performance of the Commission.

THE BCG DISCUSSION OF RECENT CHANGES AT THE COMMISSION.

The report identifies a number of positive changes in Commission operations designed to improve operations. These include the creation of Specialization teams in Enforcement, the National Exam Program in OCIE, the automated Tips, Complaints, and Referral System (TCR), and the creation of coordinating groups across divisions to reduce the silo problem.

Enforcement Changes

As the BCG report states, the Division of Enforcement appears to have made more significant changes than any other Division. The creation of units with specialized areas of expertise and responsibility is something that I advocated when I was at the Commission and something I recommended in my article on enforcement. Having said that, I do not know whether the change has been successful. Less than 20% of Enforcement staff is assigned to a specialized unit, and the number of cases these groups have brought is too small a sample to assess. So it's difficult to determine what the impact has been. BCG, however, was not reluctant to reach a conclusion. "Some of these initiatives have been completed (e.g. the reorganization of Enforcement) and are already delivering good results" (p. 73). What measures did BCG use to conclude that they are delivering good results? Were the units compared in some way to the previous structure, or to the non-specialized units in the Division? It would have been useful if BCG provided some basis for the conclusion.

The Tips, Complaints, and Referrals system

In response to the perceived failure to act upon the tips concerning the Madoff fraud, one of Chairman Schapiro's first public changes was to hire a consultant to overhaul the system used by the Commission to record and process tips and complaints.[2] The highly publicized TCR IT project revamped the Commission's technology and cross-divisional processes for handling the approximately 300,000 tips and complaints it receives each year." While BCG describes TCR as "one notable success" (p. 44), there is nothing in the report that indicates that BCG took a close look at the system before concluding that it is a notable success. The report doesn't describe how the system is used or who uses it. We don't know how many people are assigned to analyze the 300,000 tips and complaints, where the function is located, and what types of analysis they perform. BCG does not provide any substantiation for its conclusion. Is it based upon a survey of staff using the system? Is it based upon examples of successful examinations or enforcement actions that were derived from TCR? Or is the conclusion based upon the fact that the project was completed? We just don't know. It reminds me of a similarly publicized IT project about ten years ago. With similar fanfare the Division of Enforcement hired a contractor to develop an automated system to surf the Internet and find securities frauds. That system was built and operated at a cost of millions, until it was terminated around 2005 when an internal review concluded that the system had produced almost no enforcement cases.

OCIE Risk-Based Examinations Program

The BCG Report states that "OCIE continues to refine its risk-based approach to the examination process. Examination candidates are now analyzed along a spectrum of risk criteria, which are cross-referenced with tips, complaints, and referrals to identify registrants with the highest risk profiles. From there, examinations are prioritized based on a further risk assessment of the registrants' business operations, among other factors" (page 173). This is another example of a broad conclusion that lacks supporting facts. Did BCG examine the risk-based model for efficacy? Are the risk criteria different from the risk criteria that OCIE has been using for nearly a decade? What results have OCIE achieved that demonstrates an improvement in the program? What are the further risk attributes that are used in the secondary analysis? The BCG Report doesn't ask or answer these questions.

Improving Coordination at the Commission

---

[2] SEC Revamping Process for Reviewing Whistleblower Complaints and Enforcement Tips, press release 2009-44, March 5, 2009, available at http://www.sec.gov/news/press/2009/2009-44.htm.

The Report highlights several changes at the Commission designed to promote a "culture of collaboration" (page 44). In addition to the development of the TCR system, BCG identifies other efforts to improve communication and coordination. For example the BCG report states

> "The agency has also established cross-divisional task forces in other key areas of focus, such as the Consolidated Audit Trail and Life Settlements. In addition, a series of newly established meetings should help facilitate collaboration. Examples include:
>
> 1) the monthly "Trends Meeting", which is tasked with promoting open dialogue about market trends, systemic issues, and key emerging/potential risks affecting the markets that the agency regulates;
>
> 2) the regular meetings of all rulemaking functions instituted by the General Counsel to align and ensure consistency of the rulemaking efforts resulting from Dodd-Frank provisions;
>
> 3) the regular meetings of the agency-wide "Task Force on International Implementation" established by the Office of International Affairs to discuss international issues arising from Dodd-Frank rulemaking and facilitate awareness and consistency, where appropriate, across the rulemaking process;
>
> 4) regular coordination meetings between OCIE and Enforcement to discuss the status of examinations and enforcement referrals; and
>
> 5) OCIE and policy divisions have implemented several new coordination mechanisms (e.g., "One Commission" supervision strategies for large firms)."

Having highlighted these coordination procedures, the report is devoid of any analysis of the impact of these efforts. Was a survey taken of participants to gauge effectiveness? Are there specific accomplishments that have come about because of these meetings? The report is silent. As someone who attended an uncountable number of coordinating meetings during my 20 years as Commission Secretary, my cynical view is that coordinating meetings are frequently excuses to avoid serious collaboration. In my opinion the silo problem at the Commission cannot be addressed by coordinating committees. Fundamental reorganization is required.

Because the BCG report does not provide any analysis of the impact of these changes, one must be wary of ascribing too much significance to these changes. Maybe they are successes, maybe they are not. BCG does a real disservice to the Commission and to the people who spearheaded these changes by failing to conduct a meaningful assessment.

Reorganization of the Commission

The Commission is long overdue for a careful reorganization. Its current structure is complicated, confusing, and inefficient. Even after the reconsolidation of the Executive Director and Chief Operating Officer offices into a single unit that oversees the five administrative support offices, there are still 17 divisions and offices that report directly to the Chairman, and an additional 11 regional offices that report to the Chairman for certain purposes and jointly to the Directors of Enforcement and OCIE for other purposes. Additionally there are the five new offices created by Dodd-Frank that will report to the Chairman when they are created and staffed. No CEO should be burdened with so many direct reports.

Moreover, the structure is antiquated. It is a structure built on a functional regulation model that was created to mirror the clear separations in the industries that it regulates. Unfortunately the Commission is organized for the capital markets of the 1970's. The clear separations in the financial services industry that existed almost 30 years ago are now a matter of history. The dual problems of a convoluted reporting structure and a functional regulation model that no longer comports with the regulated industries have directly contributed to the inability of the Commission to do its job well. Many of the people I have interviewed for the current CCMC study have described a personal horror story about trying to persuade Commission staff in separate divisions to work together and reach a decision. The fights between T&M and IM over the regulation of registered reps of broker-dealers and investment advisors are well known. So too are the problems between T&M and IM on regulation of exchange-traded funds. Similar problems arise between IM and Corp Fin on the regulation of hedge fund offerings. IM is interested in more public disclosure and Corp Fin is concerned that greater public disclosure may interfere with the private offering exemption under the Securities Act. Meanwhile, new products and new business models developed no longer fit into the old regulatory structures. Because the divisions compete to protect their turf, decisions aren't made and innovation is stifled.

How did BCG respond to the Congressional question on reorganization? It acknowledged the need for reorganization and identified three key organizational problems that must be addressed (p. 86).

1. *Structural design of operating divisions:* The Commission needs to address issues concerning the separation of broker-dealer and investment adviser regulation and the distance between exam and rulemaking functions

2. *Operations management and support office structure:* The Commission needs to ensure operational effectiveness and efficiency agency-wide as well as in the divisions and regional offices. In addition, the Commission should simplify its support office structure and empower the role of the COO.

3. *Strategy and design of the regional model:* The Commission should assess whether today's regional structure can effectively support the national programs it has created. In developing a regional strategy, the agency should focus on: 1) location approach; 2) the balance between, and roles of, regional versus home office staff; and 3) the regional reporting structure.

Having identified these critical problems, BCG described four options for reorganization (p. 89) to address the first problem[3]. However, the Report did not make a recommendation on which option should be implemented. Similarly it did not make specific recommendations on how best to solve the second and third problems.

Instead of proposing a solution to the three problems highlighted, the report took a bold leap and recommended merging the Offices of Legislative Affairs, Office of Public Affairs, and the Office of Investor Education! Not only is this an almost trivial recommendation, it is one that is based upon a superficial analysis that the offices should be merged because they all deal with the public. If BCG had done even minimal research they would have discovered that most government agencies separate the Legislative Affairs and Public Affairs functions. A bit more research into Commission history would have revealed that Legislative Affairs and Public Affairs were, at one time, a single office at the Commission. They were split into separate offices 30 years ago because the Commission concluded that interaction with Congress and interaction with the news media are actually very different functions, requiring different skill sets and different processes. Legislative Affairs is frequently a non-public, individualized, consultative process involving sensitive information that must be kept confidential. Conversely Public Affairs by definition concerns public information, and widespread and even-handed treatment of the media. The Investor Education office also has a very different function, with a different constituency. It is

[3] One option, labeled 1c, mirrors the reorganization recommendation in the 2009 Chamber Report.

an intake process as much as it is a dissemination function. It must deal with a very high volume of inquiries and utilize standardized processes.

The failure to provide a careful analysis of the organizational problems at the Commission and make a comprehensive recommendation for reorganization is probably the most significant and glaring failure of the report.

However, while the BCG Report declines to recommend meaningful changes in Commission organization, it is not shy about making extravagant claims about the benefits of reorganization! According to BCG: "First, the initiative to implement a ***continuous improvement program***, such as lean process design, could potentially release up to approximately $25 million in annual run-rate savings based on a very high-level estimate and BCG's experience at other institutions. Second, ***the initiative to systematically redesign the organization*** could potentially release up to approximately $25 million in annual run-rate savings, although there is potential for a lag between when the initiative is launched and when the savings are realized. Together, these two initiatives could generate up to approximately $50 million in annual run-rate savings to the agency" (page 143).

What are the continuous improvement program and the initiative to systematically redesign the organization? Sadly, the report doesn't provide a clear explanation. I suppose that the explanation of what it is and how it is to be accomplished will require another multi-million dollar contract. It is unclear how a consultant can decline to propose specific agency reorganization, but conclude that whatever reorganization is ultimately chosen and implemented could result in $25 million in savings.

The SEC Modernization Act of 2011 (The Bachus Bill)

As I have stated, the CCMC and I believe that careful and comprehensive reorganization of the Commission should be a priority. The CCMC report provides a series of specific recommendations on how to improve the management of the Commission, including specific ideas on reorganization, addressing inter-divisional stalemates, reducing the management burden on the Chairman, and creating staff, office, and agency accountability. Accordingly, the CCMC and I agree strongly with Chairman Bacchus on the need for real change at the SEC and look forward to working with him and the Committee to achieve this goal. I appreciate this opportunity to comment on the ideas for reform already proposed and to offer additional ideas for the Committee to consider.

As I stated in the CCMC report, the current organization of the Commission is designed to regulate the mid-1970's financial markets not the capital markets of today. This disconnect between the regulator and the markets and participants that are regulated has directly contributed to the Commission's regulatory problems.

However, while I support the objectives of the bill, I believe that the focus of the legislation should be reoriented to achieve the transformative change that is needed to restore the Commission as the world's preeminent financial regulator. Congress must be responsible for determining the authority and powers of a government agency, for monitoring agency performance and for holding the agency accountable for its actions. The government agency should be responsible for execution and implementation of its duties. This necessarily should encompass organization structure and assignment of duties. For the same reason, I believe that the Dodd-Frank provisions requiring the creation of 5 new independent offices is a mistake and should be corrected.

My second concern is a pragmatic one. Simply put, I believe that when Congress attempts to direct and control agency operations, the agency will always retain the capacity to comply facially but not in a meaningful way. An example of this problem is §965 of Dodd-Frank. This provision explicitly states that IM and T&M must have a staff of examiners that "perform compliance inspections and examinations of entities under the jurisdiction of that Division and report to the Director of that Division." A person reading this provision would clearly assume that to comply with it the SEC would eliminate OCIE and reassign the staff into T&M and IM. Of course, that hasn't happened. As the BCG report explains, the SEC has determined to comply with §965 through a cosmetic change, rather than a meaningful change. "SEC management believes that the most effective and efficient means of implementing Section 965 would be to have a coordinating committee between OCIE, T&M, and IM and have a limited number of examiners in TM and IM whose function would include liaising with OCIE and supporting the coordinating mechanisms noted above". (Page 45, footnote 86)

No organizational chart is ever perfect. It must change over time. If the structure of the SEC can only be changed by an act of Congress, we would be exacerbating the problem we already have. An agency that is slow to adapt to changing markets would become even slower to change. Going forward, it is important to recognize that the capital markets will always change and evolve at a faster pace than the regulatory and the legislative process. So any process that is adopted must be flexible and it must be nimble to allow the Commission to change and evolve with the marketplace.

Accordingly, I believe that Congress should outline a series of principles and objectives for the Commission to achieve, such as a defined chain of command, elimination of regulatory silos and improved coordination and communications amongst divisions, and a defined regulatory plan to promote market efficiency and capital formation. The Commission would be directed, within a specified period of time, to present a reorganization plan for Congressional review, consistent with Congressional oversight responsibilities and the long-established process for review of agency reprogramming requests. I believe that the broad outlines of this approach strike an appropriate balance between executive branch and legislative branch responsibilities.

Additionally, I believe that Congress could take several steps to improve the Commission. I offer the following five suggestions:

1. ***Amend the Sunshine Act to permit the full Commission (and quorums) to meet regularly with Commission staff to discuss agency operations.*** If the Commission could informally and confidentially meet with the staff to discuss agency operations it would greatly strengthen the role of the Commission. It would also provide a vehicle for resolving conflicts between divisions and offices. It is indeed paradoxical that the Chairman can call a meeting of key staff on a moment's notice, but only if other Commissioners are not present. The benefits of a collegial decision-making body are greatly reduced if the decision makers are excluded from taking part at early stages in analysis and discussion.

2. ***Amend the Exchange Act to require the Commission to include members with essential qualifications.*** Ideally the five-member Commission should include at least one member with accounting expertise, one member with relevant legal expertise, and one member with financial markets expertise. To improve agency management it may also be appropriate to designate one member as Vice-Chairman for management, as is done at the Federal Reserve Board, and require this appointee to have experience managing a large organization. The fourth Commissioner could be someone with credentials demonstrating expertise in investor protection.

3. ***Repeal the Dodd-Frank provisions stipulating the creation of new and independent offices.*** Congress should direct the Commission as to its authority and its duties and then hold the agency accountable for effective action. It is the responsibility of the executive branch to decide how best to accomplish its mission.

4. ***Create a Second Special Study of the Capital Markets.*** The final recommendation is, in my opinion, the most important. Fifty years ago, the Commission went through a similar period when it was viewed as ineffectual, understaffed, and outgunned. At the recommendation of then Chairman William Cary, Congress appropriated funding for a special team of experts to conduct a special study of the U.S. securities markets. At the end of its eighteen-month life, the Special Study team produced a five-volume report that formed the intellectual foundation for the Commission over the next twenty years. This is an appropriate occasion to undertake a second special study.[4] Among the issues that should be addressed are the future of the U.S. and global secondary market structure, the interaction of the equity, debt and derivatives markets both in the U.S. and globally, and the development of a corporate disclosure system that reflects the needs of investors and the information technology of the present and future. An integral component of each of these issues is the regulatory agenda and operations of the Commission. The structure and role of the Self Regulatory Organization's should also be carefully examined.

H.R. 2308, The SEC Regulatory Accountability Act (Garrett Bill)

The Garrett Bill proposes to require the Commission to undertake a cost benefit analysis of all proposed rules prior to adoption. The Bill would also require the Commission to periodically review its regulations in order to determine whether they should be repealed or amended. These are important goals that I have supported personally and I know that the CCMC looks forward to working with Congressman Garrett and the Committee in achieving them.

The use of cost benefit analysis in rulemaking is a significant issue of public policy. It is particularly pertinent for the Commission in the wake of the recent decision of the D.C. Circuit Court of Appeals in Business Roundtable and U.S. Chamber of Commerce vs. Securities and Exchange Commission vacating the proxy access rule because the appellate court concluded that the Commission "failed once again adequately to assess the economic effects of a new rule".

Smart regulation requires a re-thinking of the process for developing and implementing regulations. A final regulation is the start of the process, not its

[4] In 1988 when Congress enacted the Insider Trading and Securities Fraud Enforcement Act of 1988, it authorized the Commission to undertake a second Special Study. Unfortunately, funding for the study was never appropriated. For a detailed contemporaneous discussion of this provision see Kaswell, Stuart, *An Insider's View of the Insider Trading and Securities Fraud Enforcement Act of 1988*, 45 Bus. Aw. 145 (1989).

completion. While I have long supported the use of cost benefit analysis as one component of the rulemaking process, I have also believed that the process has limitations that are often overlooked. Cost-benefit analyses are and will always be fundamentally limited. They require estimates of the impact of events that have not yet happened. Simply put, it is difficult if not impossible for any regulator to know what will happen when a regulation is adopted. Capital markets are the reflection of large numbers of individuals making individual decisions. A regulator rarely has the capacity to predict with certainty how individuals or firms will respond to a new rule. If a regulator can't predict the response, it is difficult to accurately quantify the cost of compliance or quantify the value of benefits before one knows how the industry will achieve compliance. The current means of developing cost benefit analysis may be manipulated or fail to take into account facts that may not be readily apparent yet important to the ultimate purpose of a proposed rule.

For this reason, I believe in a different approach that combines a pre-adoption cost-benefit analysis with a post-adoption look-back requirement. In 2006, I described my proposal for a new system for developing regulations in a letter published in the *Wall Street Journal*.[5]

Instead of assuming, as lawyers do, that rules are self-effectuating, the Commission should adopt a scientific approach: Consider rules as working hypotheses. Whether the anticipated reaction occurs, and at what cost, is the empirical question. Under this approach, when the Commission votes to adopt a rule it would also vote to direct its staff to conduct a thorough quantitative examination of the rule's impact:

1) The Commission's Division of Risk, Strategy and Financial Innovation ("Risk Fin") would submit a plan to collect data on compliance with the rule, associated costs, and goals achievement. Merely developing such a plan will require the staff to articulate and the Commission to accept a statement of anticipated consequences.

2) It would also provide a plan for examining the data collected to enable the agency to examine the impact, costs and benefits of the rule. Making the Risk Fin division the focal point of this assessment would provide the agency's economists and industry specialists with substantially greater leverage in shaping rules in the first instance.

[5] Jonathan G. Katz, Letter to the Editor, WALL ST. J., Aug. 8, 2006.

3) A timetable for the presentation of the results of these studies, in a published report that would be available for public notice and comment.

Under this approach, as an example, the Commission would collect data and re-evaluate a rule after a defined period, let's say two years, to determine the effectiveness of a rule, the need to keep it on the books, or to modify it. Such a periodic check of all rules would also help to determine if rules are obsolete.

This approach offers several advantages. In addition to compelling the staff to examine the rule's impact, it would fundamentally change how rules are developed. Knowing rules will be empirically examined will force the staff to carefully consider how this will be done and to develop internal discipline in the drafting process.

Institutionalizing a meaningful evaluative role for the Chief Economist will strengthen its hand during drafting of the rule. Finally, requiring the examination staff to consider these issues at the outset will cause it to be more pro-active in its inspection program, less inclined to focus on after the fact disasters and provide the Commission with more oversight of its function.

These recommendations will not result in more or less regulation, but instead they will achieve better regulation. Decisions should never be based upon a bias towards more or less regulation. Regulation must be based upon sound, fact-based understanding, and intellectual honesty. Most importantly, it must recognize that a free market is always changing in ways that can rarely be anticipated. There will rarely be a single correct answer. Regulators must accept that they will have a choice between reasonable alternatives. And when the markets move, the choice may change. So, regulation must be nimble, and regulators should never believe that they cannot or should not change as well.

I believe that an amendment along these lines would improve H.R. 2308 and cause the Commission to incorporate cost benefit analysis as an integral component of an ongoing regulatory program.

Thank you again for the opportunity to testify and to give my thoughts as the Committee looks at means of reforming the SEC and its rulemaking processes. We need to have even handed efficient regulation that insures the safety and soundness of our markets. Having smart regulators using objective information is a key point in that process. There is a direct correlation between the world-class regulator and world class markets that we enjoyed for most of the second half of the twentieth century. Restoring our markets to that status will require transformative change at the Commission and I think that today's hearing is the first step along that road.

WRITTEN TESTIMONY OF HARVEY L. PITT, "FIXING THE WATCHDOG: LEGISLATIVE PROPOSALS TO IMPROVE AND ENHANCE THE SEC" BEFORE THE HOUSE FINANCIAL SERVICES COMMITTEE

(September 15, 2011)

Chairman Bacchus, Ranking Member Frank, Members of this Committee:

Introduction

I am pleased to appear here today, at your invitation, to discuss legislative proposals intended to improve and enhance the performance of the U.S. Securities and Exchange Commission ("SEC"), as well as the legislatively-mandated report issued by the Boston Consulting Group ("BCG"), examining the SEC's structure, operations and the need for SEC reform, and the SEC's response to that report.[1]

I am currently the Chief Executive Officer of the global business consulting firm, Kalorama Partners, LLC, and its affiliated law firm, Kalorama Legal Services, PLLC (together, "Kalorama"). My testimony at this hearing represents solely my own personal views, and does not necessarily reflect Kalorama's views, or the views of any Kalorama clients or employees.[2] As the Committee is aware, I had the honor of serving the SEC in two separate tours of duty, the first as a member of the SEC's Staff, from 1968-78, culminating with my service, from 1975-78, as SEC General

---

[1] The BCG Report was undertaken pursuant to §967 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA") Pub. L. 111-203, H.R. 4173, available at http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173enr/pdf/BILLS-111hr4173enr.pdf. On September 9th, the SEC issued a response to that Report, which is available at http://sec.gov/news/studies/2011/secorgreformreport-df967.pdf.

[2] Both Kalorama firms assist businesses seeking to improve their governance, transparency and/or regulatory compliance. Neither firm is available to oppose government (or self-regulatory) enforcement proceedings. Neither Kalorama firm has received any Federal grant or contract within the current and prior two fiscal years.

I was interviewed by the team that produced the BCG Report. I did not see anything that led me to question the Report's independence and good faith. *Cf., see* David Hilzenrath, Washington Post, *Integrity of Report on SEC Questioned* (Mar. 18, 2011), *available at,* http://www.washingtonpost.com/business/economy/integrity-of-report-on-sec-questioned/2011/03/17/AB0fJ6m_story.html.

Counsel, and the second, from 2001-03, during which I served as the SEC's 26th Chairman.[3] For the past forty-three years I have either been employed by, or involved in matters affecting the SEC, and the Agency's organization, structure and efficacy are matters of great concern to me. My testimony today is based on my background in SEC operations, policies, and procedures, as well as my various positions in the private sector.

Operative Assumptions

The key to successful financial services regulation requires that this Committee embrace several fundamental premises:[4]

- ***Government is a service business.*** The role of government, in my view, is to set normative standards of behavior for those subject to its commands, and then to expend its energies facilitating the good faith efforts of those who seek to comply with legitimate government standards. Of course, it follows, as it must, that government must also take swift and effective action to redress knowing or willful violations of appropriate regulatory requirements.

- ***The overarching obligation of government regulators is, first, to do no harm.***[5] Put another way, the answer to every problem is *not* necessarily to throw another regulation at it. In adopting rules and regulations, it is incumbent upon the government to minimize its intrusion into legitimate business activities, and in a careful and intellectually honest manner to assess the likely costs and benefits of any proposed regulatory action. This also means that government has an obligation to find the least burdensome, least expensive method of solving whatever problem is the object of its efforts.

---

3 As the Committee has requested, I have attached a copy of my current resume, summarizing my education, experience and affiliations pertinent to the subject matter of this hearing.

4 Nearly eight decades ago, Congress recognized that the regulation of financial services and products is far more complex and involved than other forms of human endeavor, since the products being marketed are "intricate merchandise." H.R. Rep. No. 85, 73rd Cong., 1st Sess. (1933) 8.

5 This phrase comes, originally, from the Hippocratic Oath to which all doctors presumably subscribe, but seems even more appropriate to apply to government regulators. The Oath can be found at http://nktiuro.tripod.com/hippocra.htm.

- ***The SEC's role in the first instance is to facilitate capital formation and enhance the efficacy of our capital markets.*** Although some perceive the SEC as an enforcement agency that also has regulatory powers, in reality it is a regulatory agency that also has enforcement powers. The best way to regulate complex markets is to start by adopting clear and concise standards of conduct, and then to provide assistance to those who seek to comply with those standards. Since there will always be some who do not abide by even the clearest and most concise standards, regulators must be prepared to enforce the standards they adopt. But, by definition—when a major violation of regulatory requirements occurs, and it has become necessary for an enforcement action to be brought—our regulatory system has already failed, in one sense. The most effective form of regulation is that which is readily understood, and relatively easily embraced, by those subject to its commands, and for which there is ample assistance from regulators for those desiring to comply in both letter and spirit of applicable regulations.

- ***Effective regulation requires a constructive, collegial and respectful partnership between regulators and their Congressional overseers.*** Administrative agencies were—and remain—a brilliant invention both Congress and the Executive branch of government seized upon because neither Congress nor the President have the capacity to perform the functions necessary to ensure the expertise, attention and oversight of complex private sector activities that enhance our economic well-being. And, while the private sector may boast greater efficiencies, it is essential for these regulatory functions to be guided first and foremost by the public interest, not solely by a profit motivation.

There are, of course, additional operative principles that should guide regulators, but the principles set forth above capture the essence of the best environment to promote agency effectiveness.

Effective regulation *cannot* result if regulators are treated as if they cannot be trusted to do anything right, and whose actions or inaction is subject to contemptuous and harsh public criticism and scorn. This does not mean that agencies should be immune from criticism. But, to have a salutary effect, criticism must be constructive, not destructive. Over the last several years, it has become fashionable to treat the SEC as if it were an institutional piñata. No agency can maintain the highest standards of regulatory excellence if those who toil under its banner are demoralized by constant criticism and paralyzed by the fear that—no matter what they do or do not do—they will be criticized. For the Agency to perform optimally, there must be an effective partnership between the SEC and its oversight committees—one where Congress sets the goals to be achieved, and works to provide the Agency with the tools and, even more importantly, the trust and authority, to achieve those goals.[6]

Those who wield government power must be held accountable for the policy choices they make, those they eschew, and the natural and logical consequences of both. In turn, accountability requires holding agencies like the SEC to appropriate standards that provide, in reasonable detail, the reasons for administrative action or inaction, and explain the alternatives rejected along the path to creating new regulatory mandates. These precepts also require that Congress provide agencies with substantial flexibility to achieve Congressionally-mandated goals, flexibility that will permit the agency to adapt its regulations to new and different private-sector activities in future years, without having to receive new authorizations from Congress every time a creative and unanticipated new product or service arrives on the market.

In assessing the effectiveness of a multi-headed agency such as the SEC, there is a fundamental distinction between commissions and boards, on the one hand, and single-administrator agencies, on the other. The benefits of a commission or a board include the ability to bring a diversity of viewpoints, perspectives, expertise and regulatory philosophy to any nettlesome problem. In agencies like the SEC, collegiality becomes a major component of the agency's effectiveness. Decisions must be made on the basis of compromise, and reflect respect for a variety of perspectives. Single-administrator agencies are often capable of greater efficiency, since only one person's approval is required, but they also can succumb to a lack of independence, a failure to consider differing viewpoints, and an insularity that is the ineluctable result of having action or inaction determined solely by one individual's point of view.

<u>Regulation by Habit</u>

Agencies, like the individuals who guide them, can become set in their ways, resistant to change, and insensitive to changing dynamics all around them. One major benefit of *constructive* Congressional oversight is that it provides an external check on any agency's lapse into regulation by habit—the notion that, since the agency has always done something one way, there is no reason to consider doing it any other way. Without

---

6 Mia Hamm, a U.S. soccer legend, expressed it well when she noted that "success breeds success." Conversely, agencies that are constantly pilloried find it hard not to live down to their newly-denigrated stature, no matter how undeserved that reputation might initially have been.

Congressional oversight, the accountability of administrative agencies would be significantly diminished.

When I returned to the SEC in 2001, I had spent the immediately preceding quarter of a century in the private sector, observing the effects of "regulation by habit" on businesses. As a result, I commissioned a top-to-bottom review of the SEC's effectiveness and efficiency. Aware of the Staff's deep mistrust of those who seek to "reform" the Agency or make it more "efficient," I directed that we conduct this review by utilizing two people from every SEC Office and Division to conduct the study, with the proviso that no member of the Staff could perform the review with respect to his or her own division or office. We also hired an outside consultant to facilitate, but not to lead, the process. The result was a detailed set of recommendations on the ways that every one of the Agency's principal offices and divisions could improve its effectiveness and efficiency.

I intended to release the study to the public, but our completion of the effort coincided with the last few months of my tenure. I gave a copy to my successor, and acquiesced in his request that he be allowed to release the study after having had a chance to review it. Among the report's observations was a recognition that the SEC and its Staff tended to be reactive to marketplace events, rather than getting ahead of issues before they became crises. Unfortunately, the study has never been released, although a number of recommendations—including the creation of a risk management unit—were ultimately implemented.

As I had expected, there were Staff concerns about some of the recommendations. While I did not necessarily agree with all of the objections that were raised, I did want to accommodate legitimate concerns and demonstrate that the effort was intended solely to improve the responsiveness of the SEC to the needs of those whose businesses are affected by the Agency's activities, not to impose more onerous and unnecessary restrictions on the Staff's ability to react to situations nimbly and effectively. Putting to one side, for the moment, the substance of the BCG Report, I believe the effort embodied in the DFA—leading to the BCG Report—was an appropriate way for Congress and the SEC to collaborate on whether, and how, the Agency's powers, practices and resources should be revised or reformed.

The BCG Report having only been issued in March, and the SEC's responses to the Report only having been released last week, I believe that it is wise to give the process a chance to develop itself and move forward. There is certainly more that needs to be done, and more information that will need to be gathered. But, having adopted a sensible mechanism to look at the issue of SEC effectiveness, it is my view that Congress should facilitate the process it created, and determine whether it provides an effective way to consider important issues that clearly warrant deliberation.

Reflections on the SEC Management Review I Initiated

The review I initiated as SEC Chairman was constructive for the Agency, for several reasons. Among others, it brought the skills of some of very able Staff members to bear in evaluating how other Divisions and Offices functioned, and permitted a fresh perspective on how ably and efficiently the Commission as a whole was performing its functions. Beyond this, the mere act of rethinking how an agency performs its functions makes everyone more focused on exactly what it is the agency is supposed to be achieving, and assessing whether, and how well, the agency fulfills its mission.

Those who seek sustainable change must accept one axiomatic proposition—sustainable change for either individuals or regulatory agencies can only come from within. Change that is motivated from outside an agency, no matter how forcefully it is urged, rarely produces beneficial changes that can be sustained for significant periods of time. Periodic self-examination is beneficial, especially if it causes professionals to rethink existing approaches to problems and tasks, and to use their creativity to conjure up more imaginative and effective ways to tackle the same issues the agency has been facing for decades.

But I believe that the review I initiated could have been more consequential in modernizing and reinventing the SEC, had it been done somewhat differently. One significant improvement that could have been made in our methodology would have been to involve other groups in the process of review and reform. Congress, for example, was not a party to the processes we followed, and that effectively deprived our efforts of an important level of guidance and oversight that could have helped track our study's progress and recommendations. Additionally, knowledgeable groups that are removed from politics and government could have played a constructive role in offering objective and independent perspectives.

My concern at the time was to avoid posturing and defensiveness—two frequent responses of those whose activities are subject to efficiency reviews. In hindsight, that would have been mild compared to the criticism the SEC now seems to garner daily, even from those who presumably need no persuasion that the SEC's mission is absolutely critical for our economic growth and personal freedoms. One important role Congress can perform is to ensure that the process of self-evaluation is taken seriously, and executed in a manner that makes it more likely that the ultimate results will have appropriate utility. That, of course, is not the only—or even the most important—role that Congress can perform, but it is a significant role nonetheless. By identifying the issues it believes are worthy of review and reflection, Congress can define the scope of Agency self-examination, and ensure that the results will definitely matter.

Assessing DFA §967 and the Resulting Report

As I am sure the Members of this Committee are aware, I have been critical of a great deal of the DFA, not because the goals were not salutary, but rather because the execution did not provide any reasonable assurance, in my view, that the problems that led to DFA's enactment would readily be solved, or cabined, by the legislation. But, the preceding observations lead me to offer my strong support for the approach to self-assessment embodied in DFA §967. Congress mandated that the SEC engage an independent consultant in embarking upon a program of review and reform of the Agency. The basic elements are all present here:

- Congress provided a general framework for the SEC to engage in a process of review and reform, and included core principles to guide the process;
- The SEC was afforded substantial authority and flexibility in engaging the process of review and implementation;
- An independent outside group—BCG—was selected to offer its independent and objective guidance, and the consultant was given concrete and clear definition as to the issues on which it should focus; and
- Congress maintained its essential oversight function, to ensure that the SEC continues with the designed framework into the future.

In its review, BCG focused on four critical areas of the SEC's operations:

- Organizational structure,
- Personnel and resources,
- Technology and resources, and
- Relationships with SROs.

In addition to outlining the areas that needed to be reviewed, DFA §967 directed that the resulting Report contain recommendations regarding the possible elimination of unnecessary or redundant SEC units, improving communications between and among internal SEC offices and divisions, the need to develop a clear chain-of-command structure, particularly with respect to the work of both the Division of Enforcement and the Office of Compliance Inspections and Examinations ("OCIE"), the effect of high-frequency trading and other technological advances on the market and what the SEC requires to monitor both such trading and advances in technology, the SEC's hiring authorities, and whether the SEC's oversight of, and reliance on, SROs is necessary to promote more efficient and effective governance of our securities markets.

The BCG Report noted the SEC's demonstrated commitment to self-improvement, even prior to the passage of the DFA. As previously noted, this is an essential prerequisite to effecting sustainable change. I believe Chairman Schapiro and the current Commission deserve high praise for the efforts they have undertaken to improve the efficiency and performance of the Agency. Prior to the commencement of Chairman Schapiro's tenure, the SEC was facing the prospect of being relegated to the regulatory agency scrapheap. I believe that there are valid criticisms that can be leveled at how the SEC handled some fairly crucial issues, but having the Agency totter on the brink of extinction was never a good idea. I think the current leadership at the SEC has done a remarkable job of restoring the Commission's effectiveness, in the face of criticism that continues unabated, despite significant improvements in its performance and structure.

Of the many changes the SEC adopted on its own, its reorganization of the Division of Enforcement and OCIE, and the changes it made with respect to the positions of Chief Operating Officer and Chief Information Officer, were deemed especially noteworthy, and rightfully so. The Commission does not, unfortunately, get credit for these efforts, and they go largely unnoticed and unsung. There are valuable recommendations in the BCG Report, although no one can embrace all of them. But, of great significance to this Committee and its Senate counterpart, I believe, was the Report's recognition that, even if the SEC were fully committed to each of the Report's recommendations, optimization would only go so far, limited as a result of the paucity of the SEC's current resources.

The Report challenged Congress with an ultimatum that—at its foundation—recognizes the gross chasm between the SEC's current mandate (a mandate that seems to grow repeatedly) and its resources: the BCG Report challenged Congress to give the Agency the resources it needs to fulfill its extensive list of responsibilities, or maintain the current level of resources but narrow the Agency's mandate. I find this challenge interesting, but largely irrelevant. There is no doubt that Congress cannot, and should not, retreat from the SEC's current mandate. The

Agency has been working assiduously since the DFA's passage to introduce a host of regulatory changes that will have profound effects on our financial and capital markets. Whether that was the right approach or not is no longer a meaningful question; Congress did what it did, and there is a compelling need for it to act responsibly and give the SEC the tools it needs—and the public interest demands that it have—to succeed in meeting its many and difficult challenges.

In response to these conclusions, it has been suggested that the SEC should first demonstrate its competence, and then Congress can consider whether it should receive additional resources. Given the passage of the DFA, the syllogism implicit in this approach is:

- The SEC's past performance of its mandate is troubling;
- We have exponentially increased the SEC's existing mandate; and
- If the SEC adequately performs its exponentially-expanded mandate with inadequate resources, we will consider giving it more resources!

This reasoning, in my view lacks merit. Indeed, in many ways, it reminds me of the TV show in the mid-'60s, "Get Smart," a riff on spy-genre movies and TV shows, starring Don Adams as Agent Maxwell Smart, and Barbara Feldon as Agent 99. The opening sequence each week showed a huge, thick and closed steel door that said, in bold letters, "Knock before Entering." Right below that was a second, smaller sign, that read simply "Don't knock." If the SEC has exhibited certain deficiencies, how can piling on additional responsibilities but depriving the Agency of the necessary resources to fulfill its functions actually improve its performance?

I believe that the appropriate solution is to give the SEC what many other U.S. financial regulators possess—the ability to self-fund their operations. Doing this would provide flexibility to respond to unanticipated market developments, permit better market surveillance, enhance the SEC's technology resources, enable the agency to recruit individuals with relevant skill-sets, and enhance the critical SEC attribute of political independence.

The argument against this approach is that it would deprive Congress of the ability to see how the SEC spends the money it receives. I do not believe the SEC should be given a blank check, but rather, that it should have to account for every dollar it spends. In these times of budgetary crisis, not permitting the SEC to self-fund is the surest way to put unnecessary pressures on the Country's budget, deprive the SEC of the resources it needs to do its expanded obligations effectively, and set the SEC up for failure, no matter how hard it works and no matter how creative it is.

Other Solutions

Beyond self-funding, there are other solutions that could facilitate the SEC's improved effectiveness. In particular, in February 2003, at my direction, the Commission proposed a solution I believed was necessary back then, and even more necessary today, in light of the new rigors imposed by the DFA.

When I took office in 2001, OCIE claimed that it was examining registered investment advisers on a purported five-year cycle. I had two problems with that statement. First, based on my own experience representing many of the leading money managers, I knew the statement was not accurate. Second, and even more importantly, I was concerned that, even if accurate, a five-year cycle was meaningless: you can hide a lot of fraud in the five years between examinations! Investors are entitled to have annual or, in the case of smaller money managers, biennial, examinations of those to whom they entrust their money. As much sense as that approach might have made in 2003, it is inescapable and unarguable in 2011. The Commission is responsible for 6,000 broker-dealers, 11,000 investment advisers, numerous ratings agencies, self-regulatory organizations, 8,000 hedge funds, not to mention ATSs and other regulatees.

In February, 2003, the Commission published for comment a proposed regulatory regime that would require anyone who engaged in securities transactions with the investing public, or any segment of the investing public, to procure a compliance audit every year or every other year from a truly independent, knowledgeable compliance auditor that would be required to meet SEC qualifications and conduct examinations pursuant to guidelines and standards the SEC would set.[7] These compliance audits would be modeled after financial audits required to be obtained by public companies every year. While the requirement of an independent financial audit does not prevent financial frauds from ever occurring, it does provide a mechanism to deter those hell-bent on committing fraud, and to enable the Commission to pursue prior audits as a means of ascertaining how frauds may have been committed and how they may be redressed.

[7] *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Rel. No. 25925, Investment Advisers Act Rel. No. 2107, 79 SEC Docket 1696 (Feb. 5, 2003).

<u>Comparing the DFA Framework with the Modernization Act</u>

There are additional reasons to allow the DFA framework to continue, vis-à-vis the top-to-bottom review of the SEC that it mandated. The SEC has demonstrated a strong commitment to reform, even before the BCG Report was issued. As the BCG Report accurately notes, the SEC already has made great strides in its restructuring of both the Division of Enforcement and OCIE. Having addressed this issue legislatively within the past year, and with the effort still ongoing, it would seem prudent for Congress to let the process it commenced work its way toward a conclusion.

The SEC's restructuring of its Division of Enforcement has been underway for well over a year. To date, it has already eliminated a layer of management to streamline the Division's internal management and processes. Flattening the Division's management structure has already created efficiencies at the SEC. With the removal of unnecessary internal reviews, there is less duplication and reduced time required to complete decision-making, two flaws in an over-managed organization, freeing up additional resources to utilize in connection with substantive investigative efforts. This result is especially significant in light of the proposal in the Modernization Act to increase reporting lines by restructuring the Agency so that numerous offices report to the Office of the Chairman—an increase in management layers, leading to less efficiencies of the sort already realized by the Agency's own restructuring of the Enforcement Division.

The BCG Report also discusses the fruitful and comprehensive self-assessment the Commission has implemented vis-à-vis OCIE, a process that began before the BCG Report had been commissioned. OCIE assessed its strategy, structure, people, processes and technology to strengthen its examination program, and established an integrated National Examination Program to enhance consistency, effectiveness and efficiency across the regions. It is manifest that the SEC has begun a serious process of self-assessment and restructuring, in advance of the BCG Report, reflecting its commitment to drive significant change from within.

In this respect, the Commission has demonstrated not only that it is open to constructive criticism, but even more so that it can be relied upon to respond intelligently and effectively to its myriad responsibilities. Just six days ago, on September 9, 2011, the Commission issued a statement detailing its progress with respect to the implementation of the BCG Report's recommendations. Significantly, the SEC cites resource constraints and time demands as difficult challenges—pragmatic realities that must remain at the forefront of Congressional consideration when contemplating the current and future structure and responsibilities of the SEC.

The Commission already has taken meaningful strides, including designating the SEC's new Chief Operating Officer—Jeffrey Heslop—as the Executive sponsor for the Agency-wide analysis and implementation efforts in response to the recommendations in the BCG Report. The Commission has established "workstreams" to address the BCG Report's recommendations for further analysis and action. The Agency has even established a program management and government infrastructure in order to oversee this change initiative. There is no reason to burden this Written Statement with a recitation of everything the Commission detailed in its September 9th Response, but it is noteworthy that its release described progress on eighteen workstreams, including organizational assessments, improving personnel, cost improvements, restructuring, prioritizing regulatory activities and a host of additional efforts.

This evidences the fact that the SEC has been working for well over a year on its own reform, and has been expending a great deal of time and resources on analyzing and implementing the recommendations in the BCG Report, as mandated by the DFA. It would be short-sighted and, potentially, counterproductive to abort these efforts mid-stream, without giving them a chance to work. In discussing inefficiencies, one critical management inefficiency to avoid is veering off a path mid-way through the effort, especially where, as here, the path has proven beneficial so far. No Agency efficiencies will be realized by an about-face at this point, and much inefficiency will surely result. This is clearly not the intent of the Modernization Act's sponsors, so it is important that this Committee make sure that an undesirable and unintended consequence of that Bill does not occur.

Insofar as the obligation to perform cost-benefit analyses is concerned, it is perhaps important for this Committee to ascertain what, if any costs and benefits are likely to result from the adoption of either the Modernization Act or the Regulatory Accountability Act, or both. In 2006, I wrote an Op-ed piece that was published in the Wall Street Journal, and noted that many of "[t]he SEC's troubles can be traced to a mentality that often plagues regulatory bodies and legislative efforts: that any time a problem arises, the solution is to toss another regulation or statute at it."[8] To honor the critical values that undergird both legislative proposals—the need for greater efficiency, and developing a healthy suspicion towards additional regulation—necessarily demands that we pause before embracing a legislative solution to an existing legislative program that does not call for repair.

[8] A copy of the Article is attached hereto.

<u>The Modernization and Regulatory Accountability Acts</u>

Both the Modernization Act and the Regulatory Accountability Act stem from admirable purposes, but ultimately fall short of their intended mark. I agree with the notion in the Modernization Act that the DFA should be modified, but any modification that is proposed, much less enacted, should give the SEC more flexibility in the way it is required to implement Congressional mandates. The Modernization Act is, like the DFA, too restrictive, and does not give the SEC the requisite flexibility required if the Agency is to achieve the salutary results the sponsors of the Modernization Act would like to see.

If this Committee truly wants to assist the SEC to achieve its multiple mandates far more effectively, it should focus on giving the Agency the flexibility to govern itself so that it can adapt instantly and meaningfully to new trends, services and products that are cropping up on a daily basis. This notion is supported in the BCG Report, which found that the DFA's directive to the SEC to create five new offices, and have four of them report to the Chairman, is too rigid. Instead, the BCG Report recommends that Congress act to authorize flexibility for the Agency to organize these offices in a way that reduces duplication within existing divisions and offices. That is precisely the type of flexibility the SEC requires, and deserves, if it is to create efficiencies and a sensible management structure.

The same principle applies equally to the consolidation of offices that would be required if the Modernization Act were enacted. Interestingly, the Bill and the sponsors' statements do not discuss any cost-benefit analysis performed, or even any purported rationale, to show how the consolidations and restructuring efforts it proposes, and that how adding additional management layers under the Office of the Chairman, would create efficiencies or save on resources. Moreover, the Modernization Act would likely cause certain critical SEC functions to lose independence—for example, the Office of General Counsel—if they are suddenly required to report to the Commission's Chairman, rather than the five Commissioners.

Even apart from independence, the SEC's restructuring of the Enforcement Division already demonstrates that efficiencies result from less bureaucracy at the SEC, not more. And, beyond the SEC's own restructuring efforts, the Modernization Act would make it difficult for the Commission to effect efficiencies, since far too many employees, and far too many responsibilities, would be placed under a single office or division head. This would cause the existing offices and divisions to diffuse or lose their focus, as a necessary by-product of an increase in too many issues for which individual division and office heads would be required to assume responsibility.

The legitimate Congressional concerns that have led to the proposal of the Modernization Act can be addressed and satisfied without mandating rigid frameworks. For example, improving the SEC's technological framework for more effective communication and cross-divisional collaboration can work to solve problems that may have motivated proposed consolidations.

From an institutional standpoint, when Congress weighs in on the minutiae of an agency's organizational structure, it is reaching beyond its expertise. This is why self-assessments and independent assessments, like that of the BCG Report, are so effective, and should be given a chance to fulfill the promise that's already been shown. The Division of Risk, Strategy and Financial Innovation is another area that has already been shown to produce beneficial results. Those benefits would be lost if this new office were split up, or extinguished, as proposed in the legislation. The synergies between risk identification and management will produce many intellectual benefits that would not exist in the proposed structure that would be forced upon the Agency.

The decision to establish this Division was quite significant in the Agency's history, especially in light of emerging trends and utilizing the economic approach of logical consequences for behavior choices—something the Agency cannot afford to lose. A cost-benefit analysis of the Modernization Act, on balance, does not evidence efficiencies that could conceivably outweigh the cost of such an endeavor.

The Accountability Act

The proposed SEC Regulatory Accountability Act is focused on cost-benefit analyses, something critical for the Commission to master and perfect, and something that the Agency has not recently proven itself. As a result, regulatory accountability is quite important, but the framework proposed to achieve that result is too rigid, the same flaw from which the Modernization Act suffers.

There should be no doubt that the Agency should adopt the most efficient, least costly alternatives available to it; however, the complexity of the analysis that would be prescribed by the Accountability Act seems far too cumbersome to provide any practical guidance for the SEC to attempt to satisfy. The public would be better served if Congress were to give the SEC more general guidance, and perhaps specific guidance with respect to individual statutory requirements, to address specific issues related to the purposes behind a particular legislative provision.

Furthermore, one major difficulty in the structure of the Accountability Act is its failure to distinguish between those legislative provisions in which Congress *authorizes* the SEC to adopt rules—for example, the DFA authorization permitting, but not requiring, the SEC to adopt so-called "proxy access" rules—and those statutory provisions that *mandate* the SEC to take specified regulatory action. The two circumstances do not equally lend themselves to the kind of analysis the Accountability Act would impose.

Thus, looking at the DFA provision permitting the SEC to adopt "proxy access" rules, but not compelling that it do so, the Accountability Act articulates standards for the performance of a cost-benefit analysis, although it is not clear that a new statutory framework is needed to achieve that goal. Indeed, the notion that the SEC might be subject to different standards than other agencies raises questions that should be explored, rather than merely assuming that it is appropriate to require this Agency to engage in a burdensome analysis that its financial services regulatory peers are not required to undertake.

To her credit, Chairman Schapiro issued a very cogent statement regarding the Agency's decision not to seek further review of the D.C. Court of Appeals' proxy access decision, indicating that the Agency intended to pursue the wisdom the court's decision imparted to it. This does not seem to be the kind of situation that requires yet more standards for the SEC to meet. Since the Agency will continue adopting rules, whether or not the Accountability Act is enacted into law, it begs the question of why Congress would want to drain the Agency's meager resources even further by requiring it to litigate every single challenge to the DFA rules it must enact.

This leads to the principal drafting flaw in the Accountability Act—its imposition of onerous standards not just where the Agency has discretion whether or not to adopt a particular rule, but also in those situations where the Agency has no choice but to adopt a rule because that is what Congress directed the Agency to do. In those cases, almost without exception, the notion that the SEC must nevertheless consider such alternatives as not adopting any rule at all, is imprudent. If Congress has told the SEC it *must* adopt a rule, why should it also require the same Agency to consider whether it should not adopt any rule at all? To ask this question is effectively to answer it, and yet that is what the Accountability Act would require of the SEC.

The Accountability Act may reflect an understandable effort on the part of the Bill's sponsors to find a way around some of the mandates contained in the DFA. If Congress is troubled by some of its recent mandates to the SEC, however, it should confront that issue directly. The

SEC should not be put forced to contend with those who think the DFA was a good legislative effort and those who prefer to see it repealed. Rather than adding mandates and rulemaking obligations to the SEC's obligations, and modifying the prior DFA mandates to the SEC piecemeal, Congress should reconsider its prior mandates *in toto*. It should not, however, create an impossible burden for the SEC to try to meet. Moving forward with a blended approach will only serve to burden the SEC with an awkwardly imbalanced mandate, and is sure to result in great inefficiencies.

Administrative accountability is both critical and valuable, provided the standards established are workable, and can actually be satisfied. Of course, even if the standards established are workable, the manner in which those accountability standards are actually implemented can destroy an effective idea.

A case in point is the SEC's Inspector General, and his unprincipled approach to Agency and employee performance. Every agency has, and can benefit from, an effective, vigilant and thoughtful Inspector General. But if the incumbent is unable to conduct his reviews fairly or impartially, the IG will not enhance performance or accountability; he will produce an inappropriate environment of fear, where employees are afraid to put anything in writing for fear that anything, regardless of how innocuous it is, can be turned into some sort of purported scandal. This has the effect of reducing accountability, not increasing it.

At the SEC, the current IG apparently has no securities background. And yet, he opines on issues of substance, almost invariably finding that the Agency or its employees have acted contrary to what they should have done. Many of the criticisms leveled against hard-working, well-intending, SEC Staff members are not calculated to educate or improve employee performance, or prevent fraud and corruption; rather, they appear aligned with their consequences of destroying reputations, destroying Staff morale, and crippling true Agency effectiveness. The end result of these investigations—curiously and typically—are media headlines, which begs the question of motive.

When employees are afraid to seek assistance, put their questions in writing, or explore issues of complexity, accountability is destroyed, not enhanced. Since this Committee is interested in improving SEC accountability, it should consider the activities of a single individual, and the office he heads, who seemingly operates on the assumption that he can effectively terrorize innocent employees under the guise of upholding the law but not follow the law himself, even with respect to basic constitutional and ethical requirements, nor be held accountable for any of this behavior.[9]

Conclusion

As I noted at the outset, I am grateful for this opportunity to express my views on a broad array of important issues, all revolving around making an important regulatory agency even more effective than it has previously been. I stand ready to try to assist the Committee in any way I can, and to respond to any questions the Members of the Committee might have.

---

9 On several occasions, I have represented individuals before the current SEC OIG (as I have done with respect to his predecessor), strictly on a *pro bono* basis. I have found the process currently employed to be Kafka-esque, fraught with diatribes and bereft of professional integrity.

Free Android™ smartphone when you make a qualifying deposit of $75K.
LEARN MORE
TALK TO CHUCK
charles SCHWAB

Dow Jones Reprints: This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers, use the Order Reprints tool at the bottom of any article or visit www.djreprints.com
See a sample reprint in PDF format. Order a reprint of this article now

THE WALL STREET JOURNAL.
WSJ.com

BUSINESS WORLD | JULY 26, 2006

Over-Lawyered at the SEC

By HARVEY L. PITT

The rule of law -- first articulated in the 17th century and the foundation on which this nation was built -- holds that governmental authority must be exercised in accordance with its terms and restrictions. It is a necessary precondition for the emergence and flourishing of free-market economies in general and capital markets in particular. For markets to work, the rules must apply not only to people and businesses subject to authority, but also -- especially -- to the actions of government itself.

To descend from these theoretical heights, we turn to the SEC. Over the past 72 years, it has built a strong record of enforcing the rule of law in America's capital markets. And yet three recent regulatory fiascos in the tumultuous period between 2003 and 2005 seem to betray that history.

The SEC's twice-failed efforts to compel mutual fund boards to be governed by independent chairmen, and its now discredited effort to regulate heretofore unregulated hedge funds, may appear to be merely more examples of bad lawyering -- which, of course, they are. But there are very capable legal minds at work at the SEC, and even they couldn't salvage these rulemaking efforts. The problem was more fundamental.

The SEC's troubles can be traced to a mentality that often plagues regulatory bodies and legislative efforts: that any time a problem arises, the solution is to toss another regulation or statute at it.

Even if that bias were occasionally appropriate as an instinctual response -- a doubtful proposition -- it doesn't work at an agency that should be far more attuned to economic analysis. The SEC approached its mutual fund and hedge fund rulemaking efforts as if they presented legal issues; but they were -- and remain -- inherently economic.

Wanting to respond to the twin mutual fund peccadilloes of market timing and late trading, the SEC decided to require that funds be governed by independent chairs and a supermajority of outside directors. These were not rational responses to the economic realities of the concerns that were raised at the time.

There were four fundamental problems: First, authority over and responsibility for mutual funds actually -- and quite rightly -- resides with the investment managers, not with passive boards. In large part, this problem was compounded by the 60-year-old legislation the SEC administers: It treats mutual funds as companies when the economic reality is that they are products. Second, the SEC adduced no evidence that funds with independent chairs had functioned (or would function) any better than funds with management chairs. There was empirical data available, but it was ignored. Third, the SEC had no idea what the costs or economic effects of its regulatory solutions might be. Last, the SEC failed to adequately consider less-invasive alternatives to its majority's preferred approach.

The problems with the SEC's now-aborted effort to regulate hedge funds were even worse. While the commission concluded that it ought to extend its regulatory yoke, it failed to deliver any empirical support for that conclusion and only presented lip-service justifications. The economic reality of hedge funds is that they cater to sophisticated investors, and the SEC never adequately addressed why it should stretch its limited resources to try and cover investors who can fend for themselves. Moreover, the SEC reversed an exemptive rule it had adopted two decades earlier -- one on which hedge funds had relied to their economic detriment -- with no indication as to why or how economic reality had changed the rationale for that exemptive rule. As SEC Chairman Chris Cox testified before the Senate Banking Committee yesterday, the SEC now needs to adopt a panoply of emergency rules to undo the effects of its ill-advised prior effort to extend its regulatory reach to hedge funds.

This is surprising for an agency that's directed by Congress not simply to protect investors, but to do so by facilitating the efficiency and functioning of our capital markets, and by improving innovation and competition. It's the latter obligation that far too often gets lost in the rush to promulgate new rules and new obligations -- without doing the necessary homework beforehand or evaluating whether its existing regulations serve their intended purposes.

Ultimately, the problem with the SEC's failed rulemakings (which has permeated agency efforts since its creation) is that it's over-lawyered: The agency relies too heavily on legal doctrinarism.

In light of its capital market functions, the atrophied state of the SEC's economic analysis capacity is glaring. A steady flow of relevant information is the lifeblood of sound capital markets. If data is generated and made available, market participants can make determinations without needing government paternalism. All too often economic analyses are performed at the SEC because they're required, not because it genuinely wants to know the economic implications of its various initiatives.

The SEC has a critical mandate -- enforce the rule of law -- and it's developed a potent enforcement capability. But its sometimes excessive reliance on lawyers and rules, instead of economists and analyses, has caused the commission to stumble badly.

It's time that things begin to change. With its third foray into mutual fund regulation, there is a chance to consider solutions that will better protect the investing public, yet limit the need for heavy-handed government regulations. And, with a chance to reconsider the wisdom of any effort to regulate hedge funds, the agency has a chance to back away from an ill-advised initiative; to do that, it will require the willing assistance of the hedge fund community to shoulder responsibility for developing its own best-in-class standards that obviate the need for government intervention.

The stars now seem aligned to enable the agency to address its real mandate -- promoting efficient as well as honest capital markets -- rather than devolving backwards and reflexively deciding to pursue additional regulatory initiatives merely for the sake of appearing to have responded to perceived problems.

Mr. Pitt, CEO of Kalorama Partners, was chairman of the SEC from 2001 to 2003.

Printed in The Wall Street Journal, page A15

Copyright 2011 Dow Jones & Company, Inc. All Rights Reserved
This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our Subscriber Agreement and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit www.djreprints.com

Testimony on "Fixing the Watchdog: Legislative Proposals to Improve and Enhance the Securities and Exchange Commission"

by Mary Schapiro
Chairman, U.S. Securities and Exchange Commission[1]

Before the U.S. House of Representatives Committee on Financial Services

September 15, 2011

Chairman Bachus, Ranking Member Frank, Members of the Committee:

Thank you for the opportunity to discuss the organizational assessment of the Securities and Exchange Commission recently performed by the Boston Consulting Group, Inc. (BCG)[2]. The study was mandated by Section 967 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). My testimony will discuss the specifics of the BCG report and our plans for following up on the report's many recommendations, and also briefly discuss the two pieces of legislation included in the Committee's invitation letter concerning the SEC's organization and method of promulgating rules and issuing orders.

When I arrived at the SEC two years ago, the agency was reeling from a variety of economic events and mission failures that had severely harmed the ability of the agency to achieve its mission of protecting investors, maintaining fair and orderly markets, and facilitating capital formation. Reform was needed across the agency, and we immediately initiated decisive and comprehensive steps to reform the way the Commission operates. We brought in new leadership and senior management in virtually every office (including the Commission's first

[1] The views expressed in this testimony are those of the Chairman of the Securities and Exchange Commission and do not necessarily represent the views of the full Commission.
[2] On March 10, 2011, BCG submitted to the SEC and to the Congress its Report, *U.S. Securities and Exchange Commission: Organizational Study and Reform*. The report is available to the public at www.sec.gov/news/studies/2011/967study.pdf.

Chief Operating Officer and Chief Compliance Officer), revitalized and restructured our enforcement and examination operations, revamped our handling of tips and complaints, took steps to break down internal silos and create a culture of collaboration, improved our risk assessment capabilities, recruited more staff with specialized expertise and real world experience, expanded our training, and, through rulemaking and leveraging of public accounting firms' efforts, enhanced safeguards for investors' assets, among other things. Our goal throughout these many changes has been to create a more vigilant, agile and responsive organization to perform the critical mission of the agency.

It is clear our efforts are paying dividends. Last fiscal year, the SEC returned $2.2 billion to harmed investors, twice the agency's budget for that year. Similarly, last fiscal year, $2.8 billion in disgorgement and penalties was ordered in SEC enforcement actions, a 176 percent increase over the amounts ordered in fiscal year (FY) 2008. Our enforcement actions have ranged from complex cases against parties that played significant roles in the recent economic crisis to lesser known cases involving real harm to individual investors. Indeed, in each of the past two fiscal years we have filed more than twice as many Ponzi cases as the agency filed in fiscal 2008. Our examiners and enforcement investigators now collaborate frequently and effectively, resulting in a number of recent enforcement actions generated from examination referrals.

Although we have made significant progress in reforming the Commission, we continue to seek ways to improve our operations. Section 967 of the Dodd-Frank Act directed the agency to engage the services of an independent consultant to study a number of specific areas of SEC operations. The agency retained BCG to perform this role.

The BCG study provides an opportunity to re-examine and improve the SEC's operations. One of the benefits of the BCG study has been the opportunity for the agency to examine important first-order questions such as:

- How should SEC internal structure and operations be organized to permit the agency to most efficiently and productively carry out its work?
- How can the SEC maintain the right level and mix of resources, staff, and skills to successfully fulfil its statutory responsibilities?
- How can the SEC operate more strategically to identify, stay abreast of, and respond to technological developments and changes in the external environment that impact the agency's mission?
- How should the SEC best calibrate its reliance on and oversight of self-regulatory organizations (SROs) to promote effective and sound governance of the securities markets and its participants?

As can be seen in the Commission's first *Report on the Implementation of SEC Organization Reform Recommendations* transmitted to Congress earlier this week, we have developed the necessary program management and oversight infrastructure to address the next step in the agency's on-going multi-year change initiative. The staff is conducting a thorough analysis of each recommendation and designing appropriate approaches for those recommendations selected for implementation. We expect our next report, in six months, will describe the significant work done within each work-stream to analyze the BCG recommendations and recommend what, if any, actions should be taken.

The SEC's Mission in a Changing Environment

Over the past two decades, the markets, products, and participants that the SEC oversees and regulates have undergone a truly sweeping transformation. The changes since I was first a SEC Commissioner in the early 1990's until I returned as Chairman include such notable and far-reaching developments as:

- Major technological change and automation;
- Significant growth in the number of investors and in securities trading volume;
- Demutualization of exchanges and a tremendous growth in new trading platforms and centers;
- Increasing complexity of trading practices and products being traded;
- Growing interconnectedness of U.S. securities markets to other capital markets; and
- The ongoing evolution of the business models relating to broker-dealers and investment advisers.

As a result of these many changes, the SEC's job in executing its mission in today's complex and dynamic market environment is extraordinarily broad and challenging. We are responsible for examining more than 11,000 investment advisers whose assets under management total $43 trillion, over 5,000 broker-dealers with in excess of 160,000 branch offices, and 7,500 mutual funds. We also are responsible for the review of the disclosures and financial statements of nearly 10,000 public companies, including tens of thousands of disclosure documents each year, plus initial public offering and other public capital markets transaction filings of corporate issuers, public asset-backed securities offering documents, proxy statements, and filings related to public mergers, acquisitions and tender offers. The SEC also oversees approximately 500 transfer agents, 15 national securities exchanges, 10 nationally recognized statistical ratings organizations (NRSROs), 9 clearing agencies, as well as the Public Company

Accounting Oversight Board (PCAOB), Financial Industry Regulatory Authority (FINRA), Municipal Securities Rulemaking Board (MSRB), and other SROs.

In addition to these existing responsibilities, the Dodd-Frank Act significantly expanded the SEC's mission to include new duties with respect to regulation of over-the-counter derivatives and advisers to hedge funds, expanded oversight of credit rating agencies, greater disclosure regarding asset-backed securities, and strengthened corporate governance. In order to effectively supervise the changing financial markets and to implement our new responsibilities, the SEC must carefully examine its operations and processes to maximize efficiency and effectiveness. The BCG assessment provides useful guidance and structure for that effort.

The Boston Consulting Group's Assessment of SEC Organization and Operations

Last fall, the SEC engaged the services of BCG, a top-tier organizational consulting firm with significant capital markets expertise, to conduct a broad and independent assessment of SEC organization and operations. The SEC retained BCG for the express purpose of carrying out the assessment required by Section 967 of the Dodd-Frank Act, which required an independent assessment of the SEC's internal operations, structure, funding, and need for comprehensive reform, and the agency's relationship with SROs. Specific topics of study also included: the possible elimination of lower priority or redundant units at the SEC; improvement of internal communications and organizational chain-of-command; the effect of new market technologies such as high-frequency trading; hiring authorities and personnel practices; and oversight and reliance on SROs.

BCG was selected to conduct the assessment following a competitive acquisition process conducted in accordance with government procurement regulations and overseen by the SEC's Office of Acquisitions. The formal solicitation requesting quotations was made available to more than 1,500 government contractors who offer consulting services at rates that the General Services Administration had already determined to be fair and reasonable. Interested bidders were permitted more than three weeks to prepare and submit quotes, and this competition resulted in a contract award to BCG on October 15, 2010, within the 90-day deadline specified by Congress in the Dodd-Frank Act.

To perform its assessment and formulate its recommendations, BCG engaged in significant interaction with SEC staff, generally through interviews, to understand the existing state of the agency's operations. The agency actively encouraged staff to participate fully and candidly in interviews with BCG throughout the course of the engagement. Over the duration of the project, BCG conducted more than 300 interviews and meetings with agency employees, including myself, the Commissioners, division and office directors, and significant numbers of other agency staff. BCG set the agenda for these discussions to obtain insights into program operations, learn staff views, validate facts, test hypotheses, and otherwise acquire the knowledge necessary to successfully perform its work. In conducting its work, BCG also interviewed or met with a significant number of external stakeholders, including congressional offices, self-regulatory organizations, and entities that are regulated by or have significant interactions with the SEC.

On March 10, 2011, BCG delivered the results of its assessment to the SEC and to Congress in a 263-page final report titled *U.S. Securities and Exchange Commission: Organizational Study and Reform*. The final report, which was submitted within the 150-day deadline specified in Section 967 of the Dodd-Frank Act, reflects BCG's own independent findings and conclusions. I understand that at various points, BCG requested comments from many of us at the SEC; however, BCG always maintained full and complete control of their report, findings and recommendations.

BCG's Findings and Recommendations

The BCG study provides an opportunity for an independent look at SEC operations and to seek ways to improve how we accomplish our mission. BCG's assessment that progress has been made over the past two years to improve the effectiveness of SEC operations is gratifying. In particular, the report highlights, among other reforms, the work that has been done with respect to the reorganizations of Enforcement and OCIE, the rollout of the new Tips, Complaints, and Referrals technologies and program, and the hiring of a new Chief Operating Officer and Chief Information Officer. BCG in its report concurred that these initiatives were necessary and are proving effective.

While much progress has been accomplished, BCG concluded that the SEC still has "significant opportunities to further optimize its available resources." In other words, we have more work to do, and we agree that the need for improvement is a continuous one. BCG identifies sixteen specific initiatives that it recommends the SEC pursue to improve efficiency and effectiveness of operations. BCG classifies the recommendations into four categories:

1. Reprioritizing regulatory activities. Acknowledging that the SEC is making—and will continue to need to make—difficult tradeoffs in allocating resources to highest priority needs, the report recommends that the SEC engage in a rigorous assessment to better prioritize its needs and reallocate resources accordingly. This follow-on assessment is intended to help classify activities into different categories: high-priority activities that should be strengthened; low-priority activities that the SEC could scale back or stop; activities where the SEC could consider delegating responsibilities externally (such as to SROs); and mandated activities where SEC management could request implementation flexibility.

2. Reshaping the organization. The report recommends four initiatives by which the SEC can reshape its organizational structure, roles, and governance to maximize efficiency, effectiveness, and collaboration, and to drive continuous improvement. These initiatives are to: (1) systematically redesign the organization through a disciplined review of each division and offices' roles, accountabilities, and decision rights; (2) seek flexibility from Congress on the structure of certain new offices mandated by the Dodd-Frank Act; (3) review the authorities that the Commission has delegated to the staff and the processes by which the Commission and staff interact; and (4) implement a continuous improvement program to identify opportunities for reducing costs throughout the agency.

3. Investing in enabling infrastructure. The report concludes that significant new investment is needed in the SEC's key enabling infrastructure, specifically technology, human resources, risk management, and high-priority staff skills. The report recommends eight initiatives to: (1) enhance or develop key information technology systems; (2) transform the Office of Information Technology; (3) establish a Technology Center of Excellence; (4) reorganize the Office of Human Resources; (5) complete the roll-out of a new employee performance management system; (6) create a "surge capacity" plan to enable the agency to better navigate unanticipated short-term increases in workload; (7) enhance risk management capabilities in line organizations; and (8) hire more staff with high-priority skills.

4. Enhancing engagement with SROs. The report concludes that the SEC can improve both its oversight of SROs and its engagement with SROs. The report recommends three initiatives to: (1) strengthen oversight of SROs through enhanced disclosures about regulatory activities, develop metrics and standards to measure performance, and enhance oversight of FINRA; (2) centralize and coordinate the agency's interactions with SROs and foster greater dialogue with SROs on market trends; and (3) institute clearer processes for reviewing SRO rule proposals.

The report suggests that these recommended initiatives—particularly the initiative to systematically redesign the organization through a disciplined review of each office—will result in the identification of a number of staff who can be reallocated to work on higher-priority activities. But even assuming the reallocation of such staff through the organizational redesign initiative, BCG still concludes that the SEC will not have the personnel resources to perform all of the activities that are within the agency's responsibility. BCG estimates that there is currently a net staffing "capacity gap" of at least 435 to 485 full-time equivalent (FTE) positions in just the SEC's five divisions, exam program, and Office of Information Technology (OIT). BCG projects that this capacity gap will grow to at least 585 to 635 FTEs by FY 2013 as the result of expanded Dodd-Frank responsibilities.[3]

BCG also concludes that insufficient resources have contributed to a gap in the SEC's ability to develop needed information technology systems. BCG identifies specific shortcomings with respect to the SEC's budget and strategic investments in IT systems used for data analysis, data management, knowledge management, and workflow capabilities. BCG estimates that the SEC will initially require an additional $21 to $28 million for needed IT system improvements, with additional ongoing costs estimated at $5 to $7 million a year.[4]

Finally, Section 967 of the Dodd-Frank Act also directed BCG to provide legislative recommendations to the Congress, if appropriate. To this end, while the BCG report indicates that the SEC can optimize its resources through its recommended initiatives, it also suggests that the Congress should consider more fundamental "choices," such as whether to relax funding constraints to allow the SEC to better fulfill its current role or to change the SEC's statutory role

[3] BCG presents "net" capacity gap figures that assume that any surplus staff identified as the result of the organizational redesign initiative will be reallocated to higher-priority uses. BCG did not calculate a net capacity gap for the whole agency, but calculated these numbers only for certain large SEC offices. For FY 2011, BCG estimates the net capacity gap to include 60 FTEs in OIT and 375 to 425 FTEs in the five divisions and the national exam program (p. 55). By FY 2013, the gap for the five divisions and the national exam program will grow to 585 to 635 FTEs (see p. 198, Exhibit 7.2.3.3-1, "Capacity Gap for SEC Divisions and OCIE, 2010-2013").

[4] See pp. 110-11 of the BCG Report.

to fit available funding.[5] Additionally, the BCG report identifies several statutory constraints that add costs or inefficiency to agency operations. For instance, BCG identifies provisions in the Dodd-Frank Act that it believes create excess organizational complexity and resource fragmentation in connection with the new Offices of Credit Rating Agencies, Investor Advocate, Minority and Women Inclusion, and Municipal Securities.

Challenges

The BCG report has provided the SEC with useful insights into how the SEC might continue its efforts to ensure a vigilant, agile, and responsive organization. Given the broad scope of the BCG report's recommendations—which touch on virtually every aspect of the agency's operations and offices—determining the appropriate course of action to take in response and implementing those actions will require careful internal coordination and a significant commitment of staff and other resources.

A critical challenge facing SEC management is determining how best to stage follow-up work in the current resource-constrained environment, especially when additional work is dictated by Dodd-Frank Act deadlines. While BCG believes that its recommended initiatives will lead to efficiencies over the long-term, the report acknowledges that substantial up-front costs are required to implement the recommendations. BCG estimates that $42 million to $55 million will be required over approximately the next two years,[6] in addition to the costs associated with the significant commitment of SEC management and staff time. While some

[5] See pp. 75-77 and 147-52 of the BCG Report (discussing choices discussed in detail).
[6] BCG's estimated implementation costs consist of a $7 to $10 million investment within the first six to nine months (Wave 1), followed by an additional $35 to $45 million over the subsequent 12 to 18 months (Waves 2 and 3). See p. 143-144 of the BCG Report.

portion of these costs can be paid for through efficiency gains outlined in the report, those savings will not be sufficient to cover the full amount.

While resources are constrained in the current fiscal year, we have nonetheless allocated some funding to support a new Program Management Office to manage the logistics of following up on the BCG report. In addition, we are using current year funding to begin work on some of the critical IT priorities that BCG identifies in its report.

Because resources do not permit us to implement all the recommendations at once, our follow-up process has been focused on thinking strategically and prioritizing the various initiatives. For those initiatives that we can begin to implement now, we are working to develop realistic and achievable implementation plans and schedules for implementation. We are also carefully assessing how to move quickly while also ensuring there is sufficient time to communicate with, and give consideration to the views of, key stakeholders. Last but not least, we also are assessing how best to make use of management and staff time and to determine what pace of change the agency as a whole, or any particular office, can successfully absorb.

Progress to Date and Next Steps

In the months since the report was released, the SEC has made progress to establish processes and infrastructure to analyze the BCG study recommendations. Immediately following the issuance of the report, I designated our Chief Operating Officer, Jeff Heslop, to manage the logistics of the follow-up process. The agency has divided the BCG recommendations into approximately seventeen discrete work-streams, each assigned to a division or office director or other senior executive. We have designated this initiative as the SEC Mission Advancement Program (MAP) and have organized the work-streams around four principal goals: optimizing the agency's mission and structure; strengthening capabilities; improving controls and efficiencies; and enhancing the workforce.

The SEC has set up several "governance" mechanisms to ensure accountability and timeliness of our follow-up efforts. An effective governance structure is especially important because successful implementation of some of the recommendations appears likely to require a sustained effort over several years. As noted above, we have established a dedicated Program Management Office within the Office of the Chief Operating Officer (OCOO) as recommended by BCG to be responsible for tracking the agency's implementation efforts. We also have established an Executive Steering Committee—which is meeting regularly—to review implementation plans and advise on how best to prioritize, sequence, and harmonize the significant follow-up work resulting from the two dozen work-streams.

The next three to six months will be primarily focused on analysis of the way forward. Significant work has already been done within each work-stream to analyze the BCG recommendation and recommend what, if any, actions should be taken. In the near term, the agency's focus will be on assessing the schedule, costs, and management bandwidth required for each initiative, identifying cross-work-stream integration points, and developing a detailed prioritization and implementation plan that harmonizes and sequences all the various follow-up activities. Because many of the recommendations also touch on issues that affect the SEC's workforce, including those which are covered by the SEC's Collective Bargaining Agreement with the National Treasury Employees Union (NTEU) our follow-up efforts in certain cases will entail engagement with the NTEU.

While much work is still underway, the agency has already begun to implement a number of BCG recommendations. For instance:

- Clarifying and empowering the Chief Operating Officer. As part of its recommendation that the SEC redesign its organizational structure, BCG concluded that the SEC could simplify the support office structure by consolidating the Office of the COO and the Office of the Executive Director (OED) into one office. I agreed with this recommendation and we have implemented it.

- Building high-priority staff skills. BCG's report identifies several areas where the SEC would benefit from increasing capacity, building new organizational capabilities, and improving individual competencies. Because of funding constraints, BCG recommended that the SEC build high-priority skills by filling vacancies caused by attrition with employees who meet these needs. Consistent with this recommendation, we have focused hiring in FY 2011 on developing needed skills, including specialized industry expertise in such areas as over-the-counter derivatives.

- Establishing a Continuous Improvement Program. BCG's report recommends that the agency undertake an initiative to systematically reduce unnecessary costs throughout the organization. To accomplish this, the COO has established a Continuous Improvement Program to identify opportunities for cost savings and efficiencies in agency programs and operations, such as through streamlining of business processes.

- Improving the Office of Administrative Services (OAS). Consistent with BCG's recommendation to systematically redesign the organization, the SEC has recently launched a major initiative to improve operations within OAS, which is responsible for overseeing a number of key agency support functions, such as contracting and procurement, managing the agency's facilities and assets, mail distribution, printing, and office supplies. In July, I announced that the agency was working to improve efficiency and controls by asking the General Services Administration to manage the agency's real property leasing program going forward. We have also launched a comprehensive assessment of OAS operations, including its organizational structure, decision-making processes, reporting relationships, and quality controls. Through this initiative, we also hope to identify opportunities to improve operations, including efficiency, cost reduction, and internal controls. This assessment is expected to be completed in November 2011, and any restructuring and improvements will be implemented thereafter.

- Optimizing the organizational design of the Office of Information Technology (OIT). BCG noted that, under the leadership of our new Chief Information Officer, Tom Bayer, who joined the SEC in October 2010, "The SEC's recent momentum with regard to technology is promising." As part of its recommendation that the SEC enhance OIT's ability to deliver technology solutions, BCG suggested that OIT adopt an organization design that emphasizes increased alignment with internal clients, improved coordination with IT groups located within the program offices, and increased efficiencies by centralizing activities such as application development and project management. Since the report was issued, OIT has moved forward to overhaul its organizational design consistent with these principles.

- Redesigning the Office of Human Resources (OHR). As part of its recommendation that the SEC invest in key enabling infrastructure, BCG suggested that the SEC complete its redesign of OHR to improve personnel management. The report noted that "the SEC has taken a number of important steps to improve OHR," including "considerable progress in improving its training function." The SEC is presently at work to complete a restructuring of OHR, including to embed HR experts within the agency's operating divisions; more clearly define OHR's administration, client relation, and center of expertise functions; expand and centralize the SEC's training programs; and streamline the recruitment process. Additionally, the SEC is also moving forward with BCG's recommendation to implement a new performance management system, and is presently conducting extensive training for staff to assist with the transition to the new system.

Legislation

The Committee attached two pieces of legislation to its hearing invitation letter. The first, the SEC Modernization Act of 2011, would significantly restructure the SEC by, among other things, reducing the number of SEC's divisions, restructuring the Office of the Chairman, and modifying certain new offices created by the Dodd-Frank Act. As my testimony describes above, we are actively reviewing some similar recommendations from the BCG study to evaluate improvements in the structure, operations and processes of the agency. While I agree with several of the approaches proposed by this legislation, there are provisions of the bill that would cause me real concern. While I have a number of concerns, first and foremost, I would be very concerned about the overarching loss of the agency's flexibility in the future to change with our dynamic capital markets if its structure is rigidly established by statute. I would welcome an opportunity to work with the Committee on this legislation.

The second bill attached to the invitation letter is H.R. 2308, the "SEC Regulatory Accountability Act." The bill would establish a significant number of additional specific standards for cost-benefit analyses for Commission rules and orders. As you know, statutory requirements already explicitly require the Commission to consider the economic effects of its rules, and economic and cost-benefit analyses are fundamental components of the Commission's rulemaking process and an essential part of our work.

The bill enumerates eleven new factors for the SEC to consider in its economic analysis, each of which would create a new potential challenge to future rules. Moreover, a number of these new factors are potentially in conflict with the SEC's mission, duplicative of existing requirements, unrelated to SEC rulemaking, or unclear in scope. For example, the bill's direction to "assess the best ways of protecting market participants" could conflict with the SEC's mission. The SEC's mission is to protect *investors*, which in some cases means protecting them *from* certain market participants.

Additionally, while clear statutory statements of components of cost benefit analyses provide useful direction, those standards should apply similarly to all federal financial regulators and must be consistent with our mission. The requirements under this bill would be more extensive and more onerous than the requirements placed on other agencies. The bill would apply not only to rules, but also to orders, which could significantly impede the SEC's ability to administer the securities laws. Requiring cost-benefit analyses for orders could undermine our ability to issue enforcement orders against wrongdoers, delay exemptive orders needed to facilitate the introduction of new investment products to the market, and impede the capital formation process by delaying orders to registrants that accelerate the registration of their securities.

Concern about the appropriate balance between costs and benefits of rules is a very valid consideration in rulemaking. However, any statutory requirements should provide clear direction and include achievable standards. Otherwise, the result will be a rulemaking process that is incapable of implementing Congress' statutory directions and is consistently subject to challenge.

Conclusion

The SEC recognizes that implementation of many of the ideas in the BCG report will require a long-term commitment and sustained effort over several years to successfully implement. While we are still in the early stages of implementing the BCG recommendations, the SEC is committed to an open and transparent process. The SEC is also prepared to assist Congress should legislative action be required to implement the ideas discussed in the BCG report.

Thank you again for the opportunity to testify today. I am happy to answer any questions that you might have.

Testimony of Shubh Saumya
Partner and Managing Director
The Boston Consulting Group, Inc.
Before the Committee on Financial Services
U.S. House of Representatives
September 15, 2011

Chairman Bachus, Ranking Member Frank, and members of the Financial Services Committee, I am pleased to provide the committee with this written statement on behalf of The Boston Consulting Group, Inc. ("BCG") concerning its organizational and operational review of the U.S. Securities and Exchange Commission ("SEC" or "the agency"). This review culminated with a 263-page report of BCG's findings and recommendations. Below, we discuss the process for our review, and a summary of our findings and recommendations.

Dodd-Frank Act Mandates SEC Study

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Act") was enacted in July 2010. Section 967 of the Act directed the SEC to "engage an independent consultant of high caliber" to examine the agency's internal operations and structure and make recommendations for necessary reform. BCG submitted a proposal in response to an RFP and was pleased that the SEC selected us for this study.

The Boston Consulting Group

Founded in 1963, BCG is a global management consultancy and one of the world's leading advisors on strategy, organizational change and transformation to major corporations, public sector agencies and non-government organizations. Over the years we have responded to our client needs (both in the public and private sectors) to implement major transformation and change. To achieve this, we have invested in methodologies and tools to successfully deliver large-scale improvements in organization structure, effectiveness and efficiency for our clients. We brought a number of these core strengths to bear in our thorough study of the SEC, including a deep knowledge of capital markets, our equally deep experience in organizational design, people management and technology, and our proven track record in using this experience and expertise to great effect for our clients, here in the US and globally.

The SEC

The SEC's mission is threefold: protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. Today, the SEC oversees a large, highly complex, and rapidly changing securities market with a wide range of registrants. The agency engages in numerous regulatory activities, including registration, rulemaking and interpretation, reviewing SRO rules, investigation and enforcement, and examinations. As of the writing of our report, the SEC employed approximately 3,900 employees nationwide, which includes the home office in Washington, DC and 11 regional and district offices.

To carry out its mission, the SEC requires both a regulatory framework with clear authorizations, as well as a robust set of internal capabilities to fulfill this mandate. Our study focused on the latter.

BCG's Report and Recommendations
We conducted our study from October 2010 to March 2011. We leveraged a number of proprietary methodologies and tools, reviewed extensive documentation, undertook analyses, and conducted more than 425 discussions with current and former SEC officials, regulated entities, peer regulators, SROs, and industry groups. We focused on the four matters for study that the SEC identified in the Statement of Work for this project: 1) organization structure; 2) personnel and resources; 3) technology and resources; and 4) relationships with self-regulatory organizations ("SROs"). For each of these matters, we identified the key issues, recommended options, and noted initiatives already underway.

We submitted a 263-page report to Congress and the SEC on March 10, 2011. Broadly speaking, there are three parts to our report:

- An Executive Summary of our key findings and recommendations
- The core body of the report that addresses: Scope and approach, Context, Assessment, Strategic direction for the SEC, and Recommended initiatives
- A detailed Appendix with analyses that supplement the observations and conclusions in the core body of the report

We found that the SEC has initiated steps to more efficiently fulfill its existing mandates as well as manage its expanded mandate under Dodd-Frank. That said, however, we also found that the agency can do more. In particular, we found that there are opportunities for the agency to realign its resources to focus on the highest priority mission critical activities (as identified by the divisions and offices, themselves). In terms of organizational design, we found that the agency will need to make fundamental decisions regarding its operating model, and that the key areas of focus will include redesigning the structure of the operating divisions, increasing the focus on operational management and efficiency, formulating a clear strategy and design for the regional model, and reviewing the interaction between the Commission and SEC staff. We likewise found that more can be done to improve the agency's personnel processes and capabilities. For example, the agency needs to develop a targeted recruiting process, enhanced training capabilities, a knowledge management system, and a fully implemented and embraced performance management system, all of which must be supported by a well-functioning, service-oriented, and appropriately staffed HR team. With regard to technology, we found that the SEC today under-leverages technology in the conduct of its business. Given the SEC's expanding mandate and the increasing sophistication of the securities markets that it oversees, it is imperative that the agency address key gaps and make technology a strategic enabler. Finally, with respect to SROs, we found that there are opportunities for improvement in three areas of the agency's SRO-related operations – structure (e.g., the number of SEC/SRO touch-points), competencies (e.g., staff skills), and processes (e.g., the SRO rule review process) – which, if addressed, could enhance both the SEC's ability to oversee, and serve as a co-regulator with, the SROs.

As described in detail in our report, we developed a portfolio of initiatives which will create real efficiency and effectiveness improvements for the agency. These initiatives fall into the following four major categories:

Reprioritize regulatory activities
The SEC should engage in a rigorous assessment of its highest-priority needs in regulatory policy and operations, and reallocate resources accordingly.

- *Initiative 1: Reprioritize regulatory activities.* The SEC should undertake a structured agency-wide process to evaluate and reprioritize its mission critical activities and re-align resources accordingly. In order to do so, each division and office should classify its respective mission critical activities into four categories: high-priority activities that SEC management deems critical to strengthen or commence; activities that the SEC could, if necessary, scale back or stop entirely; activities where the SEC could consider delegating responsibilities externally, (e.g., to SROs); mandated activities where SEC management could request implementation flexibility from Congress.

Reshape the organization
The SEC should reshape its organizational structure, roles, and governance to maximize efficiency, effectiveness, and collaboration, as well as to drive continuous improvement.

- *Initiative 2a: Systematically redesign the organization.* The SEC should undertake a disciplined and transparent cascading process to re-design the organization, roles, accountabilities and decision rights to address the structural design of the operating divisions and support offices, as well as the strategy, design, and footprint of the regional model. This redesign must also take into account the reprioritization of activities and reallocation of resources described above, as well as the opportunity to streamline the management structure
- *Initiative 2b: Seek flexibility from Congress on certain Dodd-Frank mandated offices.* The SEC should seek flexibility from Congress to design its organization structure in a manner consistent with the activities required to be performed by the Dodd-Frank-mandated offices while avoiding unnecessary duplication
- *Initiative 2c: Review Commission- staff interaction processes and delegation of authority.* The SEC should review the Commission-staff interaction processes to provide clarity on delegated authority, increase transparency for the Commission in areas that are delegated, and increase efficiency in Commission-staff interactions where the Commission retains authority
- *Initiative 2d: Implement a continuous improvement program.* The SEC should undertake an ongoing initiative to systematically reduce costs throughout the organization through levers such as demand management, sourcing, and business process optimization

Invest in enabling infrastructure
The SEC should invest in key enabling infrastructure, including technology, human resources, risk management, and high-priority staff skills.

- *Initiative 3a: Enhance and develop key systems.* The SEC should enhance its existing technology and develop a new suite of systems to drive internal efficiency (e.g., by deploying workflow tools) and enable critical functionality (e.g., improve the availability of information by deploying a knowledge management system and sharing data across applications)
- *Initiative 3b: Enhance the Office of Information Technology's (OIT) ability to deliver technology solutions.* The SEC should undertake a multi-faceted transformation of OIT, which will improve the effectiveness of the information technology (IT) function to develop key technology capabilities

- *Initiative 3c: Establish a Technology Center of Excellence.* The SEC should establish a Technology Center of Excellence to institutionalize an awareness of the impact of technology on the securities markets (e.g., the effect of high frequency trading on market structure) and improve the adoption of new technology at the agency (e.g., market data analytics)
- *Initiative 3d: Execute the planned Office of Human Resource (OHR) redesign.* The SEC should undertake a multi-faceted transformation of OHR, through the execution of its restructuring plans, including a build out of the new HR Manager role, centralization of the SEC's training function, the development of a targeted recruiting process, and an enhancement of OHR's capability to support more effective people management processes within the agency
- *Initiative 3e: Complete roll-out of performance management system and link to compensation.* The SEC should accelerate the implementation of OHR's new performance management system; in concert, the agency should develop and link performance to a meaningful compensation strategy
- *Initiative 3f: Create a surge capacity plan.* The SEC should develop a short-term staffing plan that would enable the agency to navigate short-term surges in workload, particularly with respect to the Division of Investment Management and Trading and Markets
- *Initiative 3g: Enhance risk management.* The SEC should further develop and embed its risk management capabilities in the line organizations to better track key market trends and developments in a timely and actionable manner
- *Initiative 3h: Hire staff to build high-priority staff skills.* The SEC should fill vacancies caused by attrition with employees who meet high-priority skill needs

Enhance SRO engagement model

The SEC should implement initiatives to enhance its role as both an overseer of, and co-regulator with, SROs.

- *Initiative 4a: Strengthen oversight of SROs.* The SEC should enhance the disclosures SROs make about their regulatory activities, develop metrics and standards that SROs can be measured against, and enhance oversight of the Financial Industry Regulatory Authority
- *Initiative 4b: Centralize and coordinate approach to SRO interactions.* The SEC should create a central, coordinating point of contact for SRO interactions and implement structural measures that foster dialogue with SROs on market trends and related issues
- *Initiative 4c: Strengthen processes for SRO rule proposals.* The SEC should institute clearer processes for SRO rule proposals and the SEC's review thereof

We would recommend these initiatives be implemented immediately and rigorously because they are foundational to the agency's future and should, in any case, be the first major set of initiatives to be launched. Congress should then reflect on whether such optimization adequately meets its expectations for the agency's efficiency and effectiveness. This sequence is particularly important as a precise estimate of efficiencies and any future funding need can only be determined by an in-depth analysis of specific investment initiatives that target long-standing capability needs, future increases in market-driven workload, and the results of the optimization initiatives.

Proposed Legislation
We have reviewed the two legislative proposals in the context of our organizational and operational review of the SEC.

The proposed "SEC Modernization Act of 2011" (the "Modernization Act") contains a number of provisions which, based on our reading of the draft bill, appear to be consistent with options outlined in our report. Moreover, there are several provisions of the Modernization Act which appear to posit options beyond those outlined in our report. Finally, several provisions of the Modernization Act appear to go beyond the scope of our study.

The "SEC Regulatory Accountability Act" (H.R. 2308) addresses regulatory mandates that are beyond the scope of our study.

* * *

Our report entitled "U.S. Securities and Exchange Commission Organizational Study and Reform" and dated March 10, 2011, is incorporated by reference into this written testimony.

MERCATUS CENTER
George Mason University
TESTIMONY
BRIDGING THE GAP BETWEEN ACADEMIC IDEAS AND REAL WORLD PROBLEMS

FIXING THE WATCHDOG: LEGISLATIVE PROPOSALS TO IMPROVE AND ENHANCE THE SECURITIES AND EXCHANGE COMMISSION
SEPTEMBER 15, 2011

J.W. Verret
Assistant Professor of Law, Stanford University
Senior Scholar, Mercatus Center at George Mason University

United States House of Representatives
Committee on Financial Services

Chairman Bachus, Ranking Member Frank, and distinguished members of the Committee, it is a privilege to testify today. My name is J.W. Verret. I am an Assistant Professor of Law at Stanford Law School where I teach corporate and securities law. I also serve as a Fellow at the Hoover Institution and as a Senior Scholar at the Mercatus Center at George Mason University. I am currently on leave from the George Mason Law School.

My testimony today will focus on two important and necessary reforms.

First, I will argue that clarifying the SEC's legislative mandate to conduct economic analysis and a commitment of authority to economists on staff at the SEC are both vital to ensure that new rules work for investors rather than against them. Second, I will urge that the SEC be required to consider the impact of new rules on the state-based system of business incorporation.

Every President since Ronald Reagan has requested that independent agencies like the SEC commit to sincere economic cost-benefit analysis of new rules. Further, unlike many other independent agencies the SEC is subject to a legislative mandate that it consider the effect of most new rules on investor protection, efficiency, competition and capital formation.

The latter three principles have been interpreted as requiring a form of cost-benefit economic analysis using empirical evidence, economic theory, and compliance cost data. These tools help to determine rule impact on stock prices and stock exchange competitiveness and measure compliance costs that are passed on to investors.

Three times in the last ten years private parties have successfully challenged SEC rules for failure to meet these requirements. Over the three cases, no less than five distinguished jurists on the DC Circuit, appointed during administrations of both Republican and Democratic Presidents, found the SEC's economic analysis wanting. One failure might have been an aberration, three failures out of three total challenges is a dangerous pattern.

Many SEC rules have treated the economic analysis requirements as an afterthought. This is in part a consequence of the low priority the Commission places on economic analysis, evidenced by the fact that economists have no significant authority in the rule-making process or the enforcement process.

As an example of the level of analysis typically given to significant rule-making, consider the SEC's final release of its implementation of Section 404(b) of the Sarbanes-Oxley Act. The SEC estimated that the rule would impose an annual cost of $91,000 per publicly traded company. In fact a subsequent SEC study five years later found average implementation costs for 404(b) of $2.87 million per company.

That error in judgment only applies to estimates of direct costs. The SEC gave no consideration whatsoever to the more important category of indirect costs, like the impact of the rule on the volume of new offerings or IPOs on US exchanges.

In Business Roundtable v. SEC alone the SEC estimates it dedicated over $2.5 million in staff hours to a rule that was struck down. An honest commitment by the SEC to empower economists in the rule-making process will be a vital first step to ensure the mistakes of the proxy access rule are not replicated in future rules.

I also support the goal in H.R. 2308 to further elaborate on the economic analysis requirements. I would suggest, in light of the importance and pervasiveness of the state-based system of corporate governance, that the bill include a provision requiring the SEC to consider the impact of new rules on the states when rule-making touches on issues of corporate governance.

The U.S. Supreme Court has noted that "No principle of corporation law and practice is more firmly established than a state's authority to regulate domestic corporations."

Delaware is one prominent example, serving as the state of incorporation for half of all publicly traded companies. Its corporate code is so highly valued among shareholders that the mere fact of Delaware incorporation typically earns a publicly traded company a 2-8 percent increase in value. Many other states also compete for incorporations, particularly New York, Massachusetts, California and Texas.

In order to fully appreciate this fundamental characteristic of our system, I would urge adding the following language to H.R. 2308:

"The Commission shall consider the impact of new rules on the traditional role of states in governing the internal affairs of business entities and whether it can achieve its stated objective without preempting state law."

The SEC can comply by taking into account commentary from state governors and state secretaries of state during the open comment period. It can minimize the preemptive effect of new rules by including references to state law where appropriate similar to one already found in Section 14a-8. It can also commit to a process for seeking guidance on state corporate law by creating a mandatory state court certification procedure similar to that used by the SEC in the AFSCME v. AIG case in 2008.

I thank you again for the opportunity to testify and I look forward to answering your questions.

ADDENDUM TO

STATEMENT OF PAUL S. ATKINS

BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON FINANCIAL SERVICES

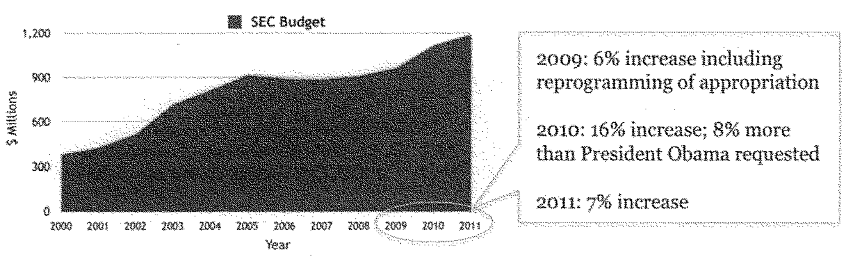
HEARING ON "FIXING THE WATCHDOG: LEGISLATIVE PROPOSALS TO IMPROVE AND ENHANCE THE SEC"

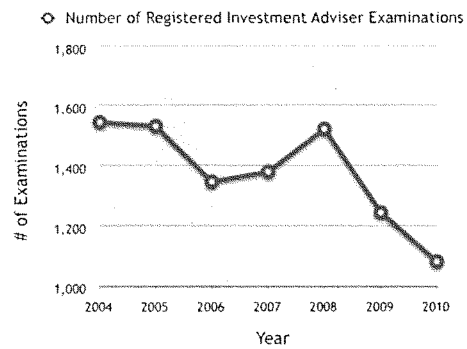
OCTOBER 14, 2011

I very much appreciate the opportunity given to me by the Committee to appear at the hearing on September 15, 2011. It was an honor and privilege for me to provide information for deliberations regarding organizational issues at the Securities and Exchange Commission.

Because of the extended discussion regarding the SEC budget at the hearing, I respectfully submit this addendum to my testimony to expand on some of that discussion.

Unlike that of most federal agencies, the SEC's budget has risen approximately threefold since 2000. In fact, since the onset of the financial crisis, the SEC budget has continued to increase. In 2010 the SEC received twice as much of a percentage increase as the President requested in his budget – it ultimately received a sixteen percent increase from the prior year. In 2009, the SEC received more money to investigate securities fraud and was granted permission to reprogram 2008 funds, resulting in a total of a six percent increase in its budget.





Source: Securities and Exchange Commission, Study on Enhancing Investment Adviser Examinations 14 (2011).

Although one might expect otherwise, at the same time that the SEC has received more funding, the number of annual examinations has actually fallen since Madoff's fraud was revealed in 2008.

Some have advocated more funding for the SEC to update its data collection and real-time surveillance capabilities. However, without trained personnel and proper management, the most expensive mousetraps will not trap mice. Should the taxpayer fund capabilities that duplicate those of other government agencies? For example, the Dodd-Frank Act created the Office of Financial Research, which is supposed to monitor the financial markets for systemic risks and potential problems. Is it possible for the SEC and the OFR to co-operate so that the SEC could utilize of some of those new capabilities? Does the SEC need a Division of Risk Strategy and Financial Innovation when the taxpayer is paying for the Financial Stability Oversight Council, which has a similar mission to the SEC's "Risk Fin" Division? Could the SEC in addition explore more ways in which it could use industry and SRO information and analytical efforts, instead of building anew?

Until the SEC has adequately attended to its management problems, increasing its budget will not necessarily lead to effective regulation or better supervision. The SEC should demonstrate how it would improve its operations before it receives more money. In the case of technology, the SEC should share with Congress a detailed plan for technology improvements, not just general aspirations, and justify its plan on a cost-benefit basis. These are basic managerial best practices that are required in private sector enterprises to ensure that resources are used effectively and efficiently.

In the past, the SEC has allowed basic policing of the securities markets to take a back seat to other policy goals (*e.g.*, competing with other regulators, trying to "push the envelope" of securities law by regulating through enforcement). That is one reason Madoff was not caught – staff was distracted and actively discouraged from pursuing Ponzi schemes in favor of other headline-grabbing enforcement actions. Thus, the SEC has become more reactive rather than proactive. More funding for data and real-time surveillance would not necessarily improve this situation, just as it would not have helped the SEC catch Madoff. In fact, many have questioned the ability – and the justification on a cost-benefit basis – of the SEC to be able to use "real-time" (versus delayed) information in a meaningful way for the protection of investors.[1]

In addition, the SEC has expended resources, especially in the wake of the financial crisis, by steadily taking politically motivated actions that accommodate special interests and hurt markets and U.S. competitiveness. For example, the SEC has promulgated costly additional climate change disclosure obligations, which depart from traditional disclosure rules to advance a specific social and environmental agenda. The SEC's pursuit of proxy access as soon as possible after the enactment of Dodd-Frank was a political accommodation to special interest groups. After the SEC decimated its staff of economists[2] and discounted so severely the importance of cost-benefit analyses, the SEC's hastily adopted rule was struck down by a D.C. appeals court for lack of meaningful economic analysis. Chairman Schapiro estimated that the SEC used approximately 21,000 staff hours to write the proxy access rule, which the agency (very conservatively) valued at $2.2 million. The SEC then used $315,000 to defend itself in

[1] *See, e.g.*, Nina Mehta and Whitney Kisling, *SEC $4 Billion Data Tracking System Is Too Costly, Virtu's Concannon Says,* Bloomberg News (June 4, 2010 12:01 AM ET), http://www.bloomberg.com/news/2010-06-04/sec-s-4-billion-tracking-system-for-trades-is-too-costly-concannon-says.html.

[2] In creating the Risk Fin division in 2009, the agency effectively downgraded the importance of economists in policy making by having them report to the chairman through the Risk Fin division director, a non-economist. This demotion in stature in the agency resulted directly in the departure of several senior economists.

court[3]. Needless to say, this money could have been better spent, and would have been unnecessary, if SEC leadership had properly analyzed its priorities.

Thus, in a time of limited resources, the SEC pursued this rulemaking that was not required by Dodd-Frank and had no demonstrated causal connection to the financial crisis. Indeed, the political pressure regarding proxy access was such that Chairman's office took the unprecedented step of intervening unsuccessfully with the enforcement division staff in the settlement negotiations with Bank of America to attempt to require undertakings regarding proxy access.[4] The unusual aspects of the case brought against Goldman Sachs in April 2010 also raise the spectre of political considerations intruding on the enforcement program.

The SEC to its credit and benefit has attracted many hard-working, bright, energetic staff members over its history. I have worked with many of them. Many of the recent mistakes were not failures of individual staff members, but rather systemic failures ultimately attributable to senior management. Until the SEC addresses the root causes of its failures in rulemaking, examinations, and enforcement, another budget increase will not provide a panacea. As this Committee acknowledged in March in its 2012 budget views, additional funding should be considered only once the SEC has "optimized its available resources." Even user fees are of themselves not an answer. They are not just "found money" – they are economically a tax, every bit as much as income, sales, excise, or payroll taxes.

Thank you for the opportunity to supplement my earlier testimony.

---

[3] Jesse Hamilton, *SEC Spent $2.5 Million on Proxy-Access Rule Rejected by Court*, Bloomberg News (Aug. 11, 2011 7:28 AM ET), http://www.bloomberg.com/news/2011-08-11/sec-spent-2-5-million-on-proxy-access-rule-rejected-by-court.html.

[4] Jesse Westbrook and David Scheer, *SEC Said to Push BofA Proxy Rule in Enforcement Case*, Bloomberg News (Feb. 18, 2010 1:35 PM ET), http://www.bloomberg.com/apps/news?pid=2065100&sid=aX5QUgmY5dAY.

QFR Responses from Chairman Schapiro
House Committee on Financial Services
September 15, 2011 Hearing, "Fixing the Watchdog: Legislative Proposals to Improve and Enhance the Securities and Exchange Commission"

Question from Representative Schweikert:

The SEC staff report on §913 recommended that the Commission – through guidance and/or rulemaking – address the vague, and therefore very challenging, implementation of the new standard that the staff recommended to be imposed. Specifically, the staff recommends the issuance of interpretive guidance or rules to inform broker-dealers on how to comply with the standard with respect to the duties of loyalty and care; form of disclosures; principal trading; and when one is providing "personalized investment advice about securities [footnote omitted]." Yet, the staff also said that existing Advisers Act precedent – some 70 years of case law – and SEC interpretive announcements and enforcement actions under the Advisers Act will apply to broker-dealers. In other words, broker-dealers will be forced to pull from seven decades of common law to determine how to comply with the new standard while they wait for a variety of new guidance to be issued by the Commission. Is that what the Commission intends to do?

Response by Chairman Schapiro:

As you know, Section 913 of the Dodd-Frank Act required a study (the "Study") evaluating the effectiveness of existing legal or regulatory standards of care for broker-dealers, investment advisers, and their associated persons for providing personalized investment advice and recommendations about securities to retail customers. Section 913 also required that the Study address whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for broker-dealers, investment advisers, and their associated persons for providing personalized investment advice.

The Commission's staff, in preparing the Study, recommended that the Commission consider adopting a uniform fiduciary standard for investment advisers and broker-dealers when providing investment advice about securities to retail customers. Specifically, the staff recommended that the standard of care for all brokers-dealers and investment advisers, when providing personalized investment advice about securities to retail customers, should be to act in the best interest of the customer without regard to the financial or other interest of the broker-dealer, or investment adviser, providing the advice. The staff recommended this new standard of care in lieu of other potential approaches contemplated in Section 913, such as eliminating the broker-dealer exclusion from the Advisers Act's definition of the term "investment adviser," which could effectively result in the wholesale application of the requirements of the Advisers Act to broker-dealers. The staff's recommendations were guided in part by an effort to establish a standard that could accommodate different existing business models and fee structures, and also preserve investor choice among products and services.

The Study also recommended that, if the Commission moves forward with rulemaking to adopt a uniform fiduciary standard for investment advisers and broker-dealers, existing guidance and precedent under the Advisers Act, as developed primarily through Commission interpretive pronouncements as well as through case law and enforcement actions, should continue to apply to investment advisers and should be extended to broker-dealers, as applicable. In particular, the Study stated that any Commission rulemaking or guidance relating to the uniform fiduciary standard should particularly focus on assisting broker-dealers with understanding their obligations in meeting the minimum requirements of a uniform fiduciary standard and what it means to generally operate under the uniform fiduciary standard. As such, the staff anticipated that the Commission would, in crafting its rules, seek to provide guidance to broker-dealers regarding compliance with the new uniform fiduciary standard.

Finally, to the extent the Commission acts on the staff's recommendations in the Study, I expect that the Commission would solicit and consider public comments before adopting any final rule.

Question from Representative Grimm:

I hear from companies that when they do have complaints about specific SEC staff or processes, they have no one to go to because the worst person to complain to about your regulator is your regulator. What are your views of the creation of an ombudsman or the outsourcing of an ombudsman where companies can go confidentially to raise concerns?

Response by Chairman Schapiro:

There are several existing avenues by which companies that have complaints about specific SEC staff or processes can voice those complaints to someone who will address their concerns. For example, in 1996, we appointed a Special Ombudsman for Small Business (SOSB) to serve small businesses and to represent their concerns within the SEC. Smaller companies can tell the SOSB about their concerns with any SEC proposal or rule or voice their complaints about specific staff or processes. Acting in a liaison role, the SOSB has worked over the years to address regulatory and enforcement issues encountered by smaller businesses. The SOSB also can answer general questions or help companies find answers to specific questions. Contact information for the SOSB is available on our website at http://www.sec.gov/info/smallbus/qasbsec.htm#eod2.

As you may know, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") also provides for the creation of an Ombudsman within the SEC.[1] Section 919D of

[1] An Ombudsman has not yet been appointed. Section 919D of the Dodd-Frank Act requires the Ombudsman to be appointed by an Investor Advocate, who is to be appointed by the Chairman to head a new Office of the Investor Advocate mandated by Section 915 of the Dodd-Frank Act. The continuing resolution that currently funds the SEC incorporates reprogramming provisions from the agency's last regular appropriation, however, which prohibit the SEC from obligating funds to establish a new office without the prior approval of the Committees on Appropriations

the Dodd-Frank Act contemplates that the primary duty of the Ombudsman, once he or she is appointed, is to "act as a liaison between the Commission and any retail investor in resolving problems that retail investor may have with the Commission or with self-regulatory organizations." Accordingly, focus of the duties of the Ombudsman appointed under Section 919D of the Dodd-Frank Act is on retail investors, rather than on companies.

---

of the House of Representatives and the Senate. Because we have not yet received that approval with respect to the Office of the Investor Advocate, I cannot appoint an Investor Advocate who, in turn, would appoint an Ombudsman.

THE CHAIRMAN

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

October 31, 2011

The Honorable Scott Garrett
Chairman
Subcommittee on Capital Markets and
Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
2244 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Garrett:

Thank you for your September 15, 2011 inquiry following the Committee on Financial Services hearing of the same date, entitled "Fixing the Watchdog: Legislative Proposals to Improve and Enhance the Securities and Exchange Commission." You noted recent press reports that indicated the Commission may undertake a broad revision of the beneficial ownership reporting rules and requested that the Commission refer this matter to its Chief Economist for thorough study in advance of proposing any changes to the rules.

The staff of the Commission anticipates conducting a broad review of the beneficial ownership reporting rules in light of modern investment strategies and innovative financial products next year. This review will include significant input from the Commission's economists in the Division of Risk, Strategy and Financial Innovation ("Risk Fin"). Once the review has been completed, the staff may make recommendations to the Commission for rulemaking.

If the Commission determines to propose changes in this area, the development of the rule will be closely coordinated with Risk Fin to identify potential economic impacts, including the costs and benefits, as an integral part of the development of the rule proposal. As with all Commission rulemaking, this collaboration and consultation would begin at the start of the process, and continue as the rule proposal develops. Drafts of any rule proposal also undergo an extensive process of review and consideration within the Commission, including review not only by Risk Fin and staff from other divisions and offices as appropriate, but ultimately each of the Commissioners and their staffs. In addition, in its proposing releases, the Commission typically includes discussion and invites public comment on the potential economic consequences of the proposed rules, including their costs and benefits, routinely requesting that commenters provide empirical data and economic analyses relating to proposed rulemakings. The Commission and staff carefully review and analyze all comments received regarding our proposed rules, including those providing empirical data and economic analyses. In its adopting releases, the Commission may revise its analyses as necessary in view of such comments.

Thank you again for your interest in the work of the Commission. Please do not hesitate to contact me, or have a member of your staff contact Eric Spitler, Director of the Office of Legislative and Intergovernmental Affairs, at (202) 551-2010, if we can be of further assistance.

Sincerely,

Mary L. Schapiro

Mary L. Schapiro
Chairman