House of Representatives Committee on Government Oversight and Reform
Subcommittee on Government Organization, Efficiency and Financial Management
and Subcommittee on TARP and Financial Services Joint Hearing

"Financial Management, Work Force and Operations at the SEC:
Who's Watching Wall Street's Watchdog?"
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For the good of America's investors, both its large institutional investors and its many small retail investors, for the capital formation America's companies need for recovery and future growth, and for the continuing dominance of America's trading markets in a competitive global environment, Congress should give our capital markets – truly one of America's great national treasures – the kind of overseer they really need.

Last summer, in the depths of the worst financial crisis in 80 years, Congress determined that the budget of the Securities and Exchange Commission needed to be doubled. Specifically, Congress took the elaborate step of formally amending Section 35 of the Securities Exchange Act of 1934 to authorize SEC budgets of $1.3 billion for fiscal 2011 (to begin on October 1, 2010, just 10 weeks later); $1.5 billion for fiscal 2012, $1.75 billion for fiscal 2013, $2 billion for fiscal 2014, and $2.25 billion for fiscal 2015.

Today, almost halfway through the new fiscal year, Congress has still not appropriated any SEC budget. The agency hobbles along at pre-Dodd-Frank funding levels, despite substantial new obligations and deadlines imposed by Congress. Worse yet, Congress is now talking about freezing or even cutting the SEC's pre-Dodd-Frank budget. The answer to any Congressional concerns is not to starve the SEC, but rather to do what is necessary to make it a strong and smart overseer that has the resources to help our capital markets recover and grow.

1. Conserving Taxpayer Dollars in a Time of Deficits

What is often forgotten in the consideration of SEC funding is that ***the American taxpayers pay absolutely nothing to run the SEC each year***. The SEC "self-funds" 100% of its annual appropriated budget with Wall Street user fees. Under a 1996 amendment to Section 31(a) of the Securities Exchange Act – adopted by a Republican Congress and a Democratic President – the money to run the SEC comes entirely from "transaction fees and assessments that are designed to recover the costs to the Government of" the entire SEC budget. Under this provision, the SEC adjusts its fee levels up or down several times each year (to take account of fluctuations in transaction volume) to fully cover its budget.

Thus, a substantially increased SEC appropriation paid for with the successful and 15-year old SEC self-funding mechanism would ***require no tax dollars*** whatsoever, and it would

add nothing to the deficit. Over the years, there has been no serious objection to the these registration and filing fees, as they are miniscule in amount relative to the transactions involved. And to avoid any perception of conflict, the SEC funds itself only out of its registration and filing fees, and never out of the disgorged profits and penalties it recovers from securities violators and turns over to investors or the Treasury.

2. "Shoestring" Financing for Capital Markets Oversight

The budget increases the SEC has gotten since Enron mean simply that it is now running on two shoestrings instead of just one. The SEC is still woefully underfunded to be the overseer of America's capital markets, surely one of our national treasures. Other national priorities – defense, agriculture, etc. – get adequate funding. But on the nation's capital markets – which one would think also merit funding – Congress has historically gone extremely cheap. Indeed in 2009 testimony, the SEC's chairman told senators that beginning in 2005, the SEC "experienced three years of flat or declining budgets, losing 10 percent of its employees and severely hampering key areas like our enforcement and examination programs."

Times have now changed. Running the SEC on a shoestring will no longer work if America wants to maintain the strength and world dominance of its markets. A strong and well-funded regulator is critical to deal with such recent phenomena as: (1) the explosion in the size of our capital markets – exponential increases in trading volume (with brokers doing thousands of trades in seconds instead of maybe a hundred trades a day), vastly more securities professionals and entities to oversee, and an influx of unsophisticated retail investors with 401(k) money to deploy; (2) trading and markets radically different and more complex than anything seen before – sophisticated and often computer-driven trading strategies, market fragmentation, and globalization of trading; (3) investment products so complex that sophisticated traders don't always fully understand what they are trading; and (4) really scary systemic risk that threatens recurring crises.

3. The Madoff Scandal

Sure the SEC missed Madoff. But so did FINRA, whose predecessor NASD installed Madoff as its vice-chairman. And so did the Justice Department. And so did the New York Attorney General – certainly no shrinking violet. And so did how many others, including the sophisticated financial services firms and professionals who regularly interacted with him. Madoff was an industry icon and idol, and nobody knew he was really a crook. Yet the SEC did bring 681 enforcement cases against 1,817 defendants in fiscal 2010, 664 cases against 1,787 defendants in 2009, 671 cases against 1,635 defendants in 2008, and 656 cases against 1,449 defendants in 2007, and with greater funding could have brought far more.

If we want to dwell on failures, we could criticize any government or private sector organization. The State Department, despite sincere efforts, regularly has its diplomatic failures, but we don't talk about defunding the State Department. And General Motors for years made cars that had trouble competing against certain foreign makes, but with GM in bankruptcy Congress came to its financial rescue. The Madoff mess is no reason to defund the SEC. It is instead a reason to give the SEC the resources it really needs to do the number of inspections and

enforcement cases that America's huge capital markets – the biggest and finest in the world – really need to function efficiently and cleanly, and to encourage the capital formation that America's businesses will need for us to see our economy grow again and create jobs and wealth.

4. The SEC's Management

The SEC's new Chairman Mary Schapiro promised and delivered on a substantial ongoing restructuring of the agency and the installation of strong new leadership. This critically important effort should not be stopped dead in its tracks for any of the particular criticisms that have been advanced to date.

(a) Pornography: The overseer of America's capital markets should not be defunded because a small number of its employees viewed pornography under a previous SEC chairman, Christopher Cox, an honorable former Member of this House. America's capital markets should not be punished for the acts of a few individuals. Nor is workplace pornography a problem unique to this agency among the many federal, state and local government agencies and among large and small private sector employers.

(b) David Becker: In early 2009, David Becker was a very successful partner in the Cleary Gottlieb law firm, where average profits per partner are reportedly $2,385,000 annually (according to statistics published in the "Amlaw 100" survey by American Lawyer magazine, a legal services industry benchmark), and given Becker's seniority, he likely earned considerably more, probably around $3 million. Based on his knowledge of securities regulation and decades of experience, he was asked to become the SEC's new general counsel at a salary of about $175,000. This would not help Becker's career, as he had already been SEC general counsel several years earlier, and for him this would be simply a repeat engagement. All it meant was that, for again serving the SEC, he would be out-of-pocket an amount likely around $6 million in lost Cleary Gottlieb compensation over the next two years he committed to serve.

Several years earlier, on his mother's death, he and his brothers had to liquidate her Madoff investment as part of closing her estate; no one has suggested this was in any way suspect, as Madoff's criminality was then still concealed. But being a careful person, on re-entering SEC service in 2009, Becker disclosed all this and got an opinion from senior ethics counsel that the speculative possibility of a future clawback claim should not in any way limit his service as general counsel. Up to the present, there is no evidence that anything Becker did as general counsel in any way hindered the Madoff trustee's recent decision to file a clawback claim against him and his brothers over their mother's estate (*Picard v. Estate of Dorothy Becker*). Notably, the trustee's clawback claim in total (with Becker potentially liable for at most a third, as he has two brothers) is far less that the approximately $6 million Cleary Gottlieb compensation Becker gave up to serve the SEC for the last two years.

(c) Updated Spreadsheets: Nor should the overseer of America's capital markets be starved of resources because the Government Accountability Office criticized things like how the SEC has kept track of the disgorged profits and penalties it collected from defendants and safely deposited in court bank accounts for investors or in the U.S. Treasury. In this regard, the GAO's problem was primarily that SEC spreadsheets tracking what it had collected were not rigorously

updated, not that the funds were really at risk. If the SEC were not run on such a shoestring for so long, it would be able to hire more green-eyeshade types to prepare beautiful spreadsheets for GAO. Instead, operating on a shoestring as it long has, it puts as many of the troops as it can on the front lines fighting the fraudsters.

(d) Leases – 9/11 Shelter and Congressional Orders to Expand: The SEC's leasing activity is likewise no reason to cut the oversight of America's capital markets. The money spent on unused New York space arose from the fact that the SEC's New York offices, next door to the World Trade Center, were reduced to rubble on 9/11. With everybody out on the sidewalk, the SEC shoe-horned its New York staff into the only available space, which was too small and had an exceptionally inefficient configuration (as this witness personally observed). When suitable space became available (the space the SEC now occupies in New York), they were stuck with some of the space they took in the 9/11 crisis.

The recent lease that the SEC signed for space in a second building in Washington, about 10 blocks from SEC headquarters, came after Congress determined in the statutory text of Dodd-Frank that the SEC's budget would double over five years. Congress gave the SEC new responsibilities over hedge funds, derivatives and credit rating agencies, as well as a strict timetable for mandatory Dodd-Frank rulemaking, and told the SEC to get moving in a hurry. When the SEC looked for space to house the new staff needed to do what Congress ordered, the database of available real estate presented two choices: (1) rent spaces in several buildings and spread the staff around Washington (very inefficient), or (2) rent the one and only available space (before somebody else grabbed it) that would be big enough to hold all of the new people in a single second building (obviously far more efficient). The SEC rationally took the second choice. Now just months later, Congress is threatening to pull the budget rug out from under the SEC. (The building in question is a rehab underway of an old government-tenant office building that long stood vacant, sits in a wasteland of grim-looking government buildings in Southwest Washington, and is certainly not "prime" office space.)

5. The SEC's Need for Additional Funding

This is not about funding Dodd-Frank. This is instead about maintaining at acceptable levels the core activities that have been at the heart of the SEC's Congressional mandate for many decades. Right now, the SEC is running on empty. The SEC's Enforcement Division is cutting back on investigations, letting vacancies in important agency programs go unfilled, and cancelling technology upgrades needed to process the oceans of data it gets each month. Its Inspections Office is being forced to cut the number and frequency of its examinations of financial firms, which were already very infrequent due to historic underfunding of the agency. Its acclaimed plan to bring in Wall Street trading experts with the sophistication to understand and appropriately respond to today's complex trading and markets, including the new technologies and strategies that may have had a role in last year's "flash crash," will never achieve its promise without funding.

Investors sidelined with decimated 401(k)'s will be unwilling to again risk their capital if Wall Street's cop-on-the-beat increasingly comes to be seen by the public as a cop-on-furlough. Investor perceptions are critical, and without the strong return of individual investors and the

conservative investment funds that hold much of their remaining wealth, America's road to economic recovery will be far longer and more difficult. Regardless of differing views about certain Dodd-Frank provisions, America's businesses, which now more than ever need to aggressively draw investment capital, will surely be hurt by any investor perception that lack of funding is sharply curtailing the SEC's ability to protect investors and maintain market integrity.

6. Separating Politics From SEC Funding

Over the years, many have suggested putting the SEC on the same footing as the federal banking agencies by adding to the SEC's existing "self-funding" something new – the ability to "self-*budget*." Self-budgeting, which the self-funded federal banking agencies have done for many years, lets the banking agencies set their own budgets on a timely and adequate basis, and without getting lost in the inevitable political complexities of the annual appropriations process. This lets the banking agencies in times of crisis respond quickly to changes in staffing and other program needs, and lets them engage in long-range (multi-budget-year) planning, by setting their own budget levels (self-budgeting) and then paying their own way through user fees (self-funding).

Of course, while benefiting from a self-budgeting process, the SEC would always remain subject to Congressional oversight. If Congress is concerned, it can call hearings to demand explanations, and if still not satisfied Congress can legislate to correct any perceived problems. The banking agencies remain keenly aware that they must use their self-budgeting power prudently, or Congress will modify it or take it away entirely, and the SEC would be just as mindful of this reality. Congress' determination to put the banking agencies on this funding basis has proven to be a success story over many years, and it would be just as successful a means for funding the SEC.

The present dilemma underscores vividly why continuing to involve the SEC in the uncertainties and inevitable delays necessarily inherent in the annual appropriations process is not in the best interest of American business or investors. The situation presently confronting the SEC is indeed serious – with frozen funding levels forcing curtailment of inspections, enforcement and other vital activities, and all at a time of globalized capital markets, more complex and opaque instruments than ever before, and electronic trading techniques that require expertise and intensive broad-based monitoring and evaluation.

Congress has long recognized that the SEC is woefully underfunded, and it has already explicitly amended Section 35 of the Securities Exchange Act to authorize a doubling of the SEC's budget over the next five years. With the SEC already funding itself through miniscule user fees and not through tax dollars, it makes sense to simply adopt for the SEC the self-budgeting approach that has worked so efficiently and for so long for the banking agencies – for the good of investors, the health of our trading markets, and the encouragement of capital formation at a time when it is so seriously needed.

7. Conclusion

Protecting America's investors (large and small) from investment fraud, restoring integrity to the markets, and encouraging capital formation for America's businesses by drawing investors back into the markets are priorities too important to sacrifice. For America's capital markets to maintain their dominance on the world financial stage, Congress should fund the strong, smart and effective SEC that Mary Schapiro and her team are poised to deliver.