TESTIMONY

TESTIMONY OF
JAMES M. McCONNELL, EXECUTIVE DIRECTOR
U.S. SECURITIES AND EXCHANGE COMMISSION CONCERNING
CRITICAL RESOURCE AND STAFFING ISSUES FACING THE SEC

BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF GOVERNMENT MANAGEMENT, RESTRUCTURING AND THE DISTRICT OF COLUMBIA OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS

UNITED STATES SENATE
April 23, 2002

Chairman Durbin, Senator Voinovich, Members of the Subcommittee:

Thank you for the opportunity to testify before you today on behalf of the Securities and Exchange Commission to discuss critical resource and staffing issues that the Commission faces in its oversight of our increasingly complex financial markets.

Introduction

The events of September 11th, the bankruptcy of Enron and the more recent indictment of Arthur Andersen have all tested the strength, security and spirit of our economy, our capital markets and indeed our Country. In light of these events, and as the complexity and utilization of our financial markets continues to grow unabated, the Commission must have the resources it needs to fulfill its multiple missions and to maintain the public's full confidence in our capital markets.

The SEC regulates industries and markets that have grown enormously in both size and complexity. The Commission currently oversees an estimated 8,000 brokerage firms employing nearly 700,000 brokers; 7,500 investment advisers with approximately $20 trillion in assets under management; 34,000 investment company portfolios; and over 17,000 reporting companies. The Commission also has oversight responsibilities for nine registered securities exchanges, the National Association of Securities Dealers, the National Futures Association, 13 registered clearing agencies, and the Municipal Securities Rulemaking Board.

The Commission today faces some of the most complex and difficult issues it has ever considered. No segment of American business has been more transformed by the rapid pace of technological innovation in recent years than the securities industry. New technologies, new participants, and new financial products are reshaping our markets. Our markets also are becoming increasingly global - a trend that most expect to accelerate in the coming years. Moreover, our national securities markets are taking steps to shed their long-held membership status and are moving to become publicly held entities. In addition, online trading and new technologies have empowered individual investors in ways that were previously unimaginable

We are a nation of investors. In 1980, only 5.7 percent of Americans owned mutual funds. Today, some 93 million shareholders, representing 52 percent of U.S. households, hold mutual funds. Our nation's investors have an unprecedented stake in our markets. Whether through college savings plans or retirement accounts, our collective stake in U.S. markets continues to grow, and we are increasingly dependent on the success and integrity of those markets. In short, it is now more important than ever that the SEC remain vigilant in policing and maintaining the integrity and transparency of our securities markets.

Unfortunately, at the very time the challenges facing the Commission have grown, the Commission has been subject to extremely high attrition, principally because our employees earn substantially less than their counterparts in the private sector and even those who work for the other financial service regulatory agencies. Perhaps the single largest barrier to the Commission's effective recruitment and retention efforts was eliminated with the recent enactment of "pay parity." This critical legislation does not mean – nor should it – that SEC employees will be paid at the level of the private sector. It does, however, redress the obvious disparity that previously existed between SEC employees and employees of the federal bank regulatory agencies. Pay parity, when fully funded on a permanent basis, will help the Commission attract highly qualified staff who might otherwise decline employment with the SEC; it will also undoubtedly help the Commission retain its highly qualified staff. The legislation had the added benefit of establishing a stable, long-term funding source for the Commission, even after the meaningful fee relief provided under the legislation. In fiscal 2003, for example, the Commission will collect approximately $1.3 billion in securities-related fees. Even after fully funding pay parity and the additional positions we have requested for fiscal 2003, the Commission will still collect over $750 million more than our budget.

The Subcommittee has raised the issue of whether or not, in light of the collapse of Enron, our government has adequate staff to monitor publicly traded companies. I commend the Subcommittee for tackling such a critical issue. In fact, the Commission itself is engaged in a comprehensive review of the SEC's resource needs and operations. When Chairman Pitt came to the SEC last fall, he expressed his intention to perform an in-depth review of the Commission's operations, effectiveness, and resource needs in time for the fiscal 2003 budget process. The extraordinary events of the past eight months, including the destruction of our Northeast Regional Office, which was located in the World Trade Center complex, made any contemplative review of our resource needs impossible until recently. Though the extraordinary demands on the Commission's resources continue unabated, last month Chairman Pitt announced the commencement of a four-month internal special study to examine our resource allocations and needs to allow the results of the study to be part of the fiscal 2004 budget process, which starts in August with our submission to the Office of Management and Budget. This special study is also a direct result of the findings of the General Accounting Office as set forth in its two recent reports on certain aspects of the SEC's operations. We hope the special study will provide comprehensive and useful answers to the very questions that bring me before you today.

In my testimony today, I will address the steps the Commission has taken on the Subcommittees' stated topic of concern, which include our efforts to achieve, and now fund, pay parity; our immediate request for 100 additional personnel; our implementation of the special study to address resource-related issues; and the Commission's response to two recent reports issued by the General Accounting Office.

Pay Parity

With the recent enactment of the Investor and Capital Markets Fee Relief Act, which authorizes the SEC to create a compensation system comparable to the systems of other federal financial regulators, the Commission finally is in a position to address the compensation issues at the heart of our serious recruitment and retention problems – provided the SEC receives the ongoing funding to do so.

The SEC intends to make responsible increases in staff salaries and benefits and to ensure the appropriate use of merit and performance-based principles. We have described our plan to implement pay parity in our Pay Parity Implementation Plan and Report that we submitted on March 6, 2002 to the Congress (including the Senate Committee on Governmental Affairs) and the Office of Personnel Management.

In developing our compensation system, we strove to strike a delicate balance among competing interests that include the goals of the Administration, the concerns of Congress, and equity issues within the agency. Recognizing our responsibility to appropriately manage performance as we improve staff compensation, our system includes strong merit/pay-for-performance principles, as opposed to large, across-the-board pay increases that may be inappropriate for the federal service. Moreover, our $76 million cost estimate represents a conservative approach to obtain comparability with the other federal financial regulators. We believe this will allow us the opportunity to ascertain over time how well our system is working before we become locked into a structure that might not meet our goals. In addition, to begin the program we plan to maintain the same benefits as are currently available to all Federal employees. It will take some time and additional funds to implement a more expansive benefit system.

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

In order to implement the new compensation system this fiscal year, the Commission has requested and obtained authority to use $25 million from its no-year funds. We are actively seeking funding to assure that the new compensation system can continue in fiscal 2003. Failure to continue funding pay parity beyond fiscal 2002 would only exacerbate the problems that the legislation passed by Congress last December was intended to cure. By temporarily raising salaries and expectations of finally achieving lasting pay parity relief, we believe we will face even greater employee losses and suffer irreparable harm to morale if pay parity is not funded in fiscal 2003, and thereafter. The threat of either terminating our pay parity program in fiscal 2003 or terminating approximately 700 employees — the number we estimate would have to be cut from the agency to continue pay parity — would cripple many of the projects we have underway, which are important for the protection of investors and Americans whose retirement accounts are invested in the securities of public companies.

We hope to make pay level increases in the pay period beginning May 19th in a manner consistent with the Pay Parity Implementation Plan and Report. We have had both preliminary discussions and a detailed pay system briefing with the National Treasury Employees Union and are advised that negotiations will commence next week. We are making, and will continue to make, every effort to complete negotiations by May 19th so that all employees will enjoy the benefits of pay parity at the same time. Each day of delay past May 19th will mean that our staff will not receive increased pay for which we have funding since we cannot make pay levels retroactive. After so many years of working for pay parity, the Chairman does not want to let a single day pass in which pay parity funds are available, but are not used, to increase the pay of the hard-working employees of the Commission.

Pay parity has been and remains Chairman Pitt's highest budget priority. This is a crucial time in the development and strategic future direction of our capital markets. The SEC cannot afford to continue suffering the staffing crisis it has endured for the past decade at such an important juncture. Pay parity, once fully funded, will provide the benefits we truly need to meet the increasing regulatory challenges we face.

Immediate Additional Staffing Needs

Because of recent events, and because of the sheer size and complexity of our markets, we need to act fast to maintain full confidence in our capital markets. We believe we cannot do that without additional personnel. Accordingly, when Chairman Pitt testified on the SEC's budget before the Senate last month, he requested that our fiscal 2003 staffing level be increased by 100 positions to meet our immediate resource needs. Since that hearing, the Administration has submitted its supplemental budget request to Congress and included in it $20 million to fund these positions in fiscal 2002 and fiscal 2003. We are very grateful for the Administration's support. They have been extremely receptive to our request and willing to work with us to meet our resource needs. These 100 positions would allow us to add.

- 35 accountants and lawyers in the Division of Enforcement to deal with the increasing workload from financial fraud and reporting cases. To give you a sense of scale of this increasing workload, consider that over the first three months of this year, the Division of Enforcement has opened 64 cases investigating financial fraud and reporting, compared to approximately half that number of cases opened over the same time period last year.

- 30 professional staff, including accountants and lawyers, in the Division of Corporation Finance to expand, improve and expedite our review of periodic filings. Our Division of Corporation Finance has undertaken to monitor the annual reports submitted by all Fortune 500 companies that file periodic reports with the Commission in 2002. This new initiative, which we announced in December, significantly expands the Division's review of financial and non-financial disclosures made by public companies.

- 35 accountants, lawyers, and other professionals in the other divisions – including the Office of the Chief Accountant – to deal with new programmatic needs and policy.

These 100 positions are the absolute minimum staffing levels we believe we require to deal with our *immediate* post-Enron needs.

Special Study

In March, we began a special four-month study to assess our resource needs in preparation for our upcoming fiscal 2004 budget submission. The study has three principal objectives: 1) to identify means to improve agency quality, efficiency, timeliness, and productivity with the existing resources available; 2) to determine whether the SEC requires additional resources (including personnel, technology, and training) to successfully fulfill its statutory responsibilities in light of the external environment in which it operates, and, if so, how much is needed, either immediately or long-term; and 3) to examine how the agency can operate strategically, by developing and implementing methods to rapidly identify trends and changes in the external environment so that it can respond and act effectively and on a timely basis, consistent with the goals of the President's Management Reform Agenda and the Government Performance and Results Act.

The special study is intended, in part, to implement the GAO's conclusion that strategic planning could help the SEC better identify and manage its resource needs. The special study is being conducted by mid- and senior-level staff from divisions and offices throughout the agency with working experience in more than one of the major divisions or offices. An outside consulting firm with expertise in both private and government legal settings is assisting this team. The study is examining and documenting the current operations of the agency, focusing on workload, resource allocation, methods for assignment and management of work, and existing means of measuring performance, productivity and quality of effort. Commission staff leading the study have already apprised the GAO and the OMB of this effort and solicited their views, and intend to continue to do so throughout the study.

We anticipate completing the study by the end of July. While we cannot predict what the results of our in-depth evaluation will be, we are asking ourselves tough questions and remaining mindful of the competing and important priorities our government faces.

The special study team welcomes comments from the public. Comments should be directed to SpecialStudy@sec.gov or to Special Study Team, Office of the Executive Director, U.S. Securities and Exchange Commission, 450 Fifth St., N.W., Washington, D.C. 20549.

Responses to the GAO Report on Human Capital

In addition to implementing the special study, the SEC has also taken numerous steps in direct response to last year's report of the General Accounting Office entitled Securities and Exchange Commission: Human Capital Challenges Require Management Attention (GAO-01-947). This GAO report confirmed that "inadequate compensation is the primary reason that employees leave the agency." While recognizing the appropriateness of the SEC's efforts to ameliorate its staffing crisis by seeking pay parity with the banking regulators, the GAO made several additional recommendations to improve the SEC's human capital management practices. We have taken and will continue to take steps to implement these welcome recommendations, and I will now briefly address those relevant to today's hearing.

Formal Employee Surveys

The GAO recommended that the SEC use formal approaches, such as periodically surveying employees, to evaluate job satisfaction and morale, identify employee concerns, and analyze the effectiveness of the agency's use of flexibilities and work-life programs. Commission staff previously indicated to the GAO that we would review the results of the GAO survey and the 2001 Office of Personnel Management survey, and would further survey employees "as needed." While finding this to be a "useful first step," the GAO recommended that a systematic process for an independent survey be established, so that fact-based measures may be used to determine the success of initiatives, gauge morale, and identify concerns on an ongoing basis.

The Commission understands the importance of surveys as a tool to measure the morale and learn about the concerns of its employees. The SEC intends to continue to take the steps necessary to examine the level of employee morale and job satisfaction, and our special study does this explicitly. As part of this effort, the Commission is developing and will implement a more formalized survey system.

Involve Human Capital Leaders in Decision-Making

The GAO also recommended that the SEC identify ways to involve human capital leaders in decision-making and establish a practice that requires management to monitor and refine the SEC's human capital approaches to ensure their ongoing effectiveness in addressing employees' needs, including working with the National Treasury Employees Union to address expeditiously areas of dissatisfaction identified in the GAO report. These areas include opportunities for advancement and the quality of administrative support services.

Although the level of consultation between the SEC's senior management and human capital leaders has historically been very high, the Commission is working very hard toward formalizing the process. Specifically with regard to working with the NTEU on the areas of concern noted in the GAO's report, Commission representatives are presently conducting negotiations with the NTEU on a collective bargaining agreement that should help address these concerns.

Responses to the GAO Report on SEC Operations

In addition to the foregoing, the SEC has taken many steps in response to the recent report of the General Accounting Office entitled SEC Operations: Increased Workload Creates Challenges (GAO-02-302). This GAO report reviews how the securities markets have changed and evaluates whether the SEC's resource levels have affected its ability to regulate and oversee the markets.

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

Findings in the GAO report go to the core of the Chairman's view that government is a service business, consistent with the Commission's overriding investor protection mission. Being a service business does not mean saying "yes" to any and all parties. It does mean that the Commission and its staff, as public servants, have an obligation to reach decisions and provide answers as quickly and as efficiently as possible so that government does not end up inadvertently impeding a vibrant and growing economy. The promptness with which the Commission responds to its many constituencies is one of several objectives of the special study.

While recognizing the SEC's efforts to address its resource challenges, the report recommends that the SEC develop short-term and long-term strategies to address these challenges. As discussed below, we are taking steps to implement these recommendations.

Short-Term Strategies

The GAO recommends that, in the short-term, the SEC take definitive steps to continue to address its turnover problem and fill its vacant positions. The GAO indicates that these actions should include exploring use of the SEC's no-year funds to expand recruiting and retention efforts to ensure that all available resources are maximized to attract and retain staff. The GAO also recommends that the SEC explore innovative ways to attract senior level staff and bring in additional information technology expertise to better position itself to oversee evolving securities markets.

The Commission understands the importance of addressing our staffing needs. As discussed above, we hope to be in a position to implement pay parity for all employees by May 19th. The Commission has also worked diligently over the last several years to take advantage of recruiting and retention tools available to it under Title 5.[1] The Commission will continue to use these tools and explore innovative ways to attract and retain staff, even after the implementation of pay parity. Ultimately, however, the solution to our recruiting and retention difficulties depends in large part on the ability to compensate our employees adequately, a solution that could be largely achieved with the full and ongoing funding of pay parity.

Long-Term Strategies

The GAO also recommends that, in the long-term, the SEC broaden its strategic planning process to systematically determine regulatory priorities and resource levels to fulfill its mission. Once this is completed, the GAO recommends that the SEC link the strategic plan to staffing allocation and workforce determinations and expand its existing recruiting efforts to include any additional disciplines identified as necessary to effectively regulate evolving securities markets. Our special study is a critical first step in accomplishing this, and we look forward to employing the results of the study to better fulfill our important mission.

Conclusion

The SEC currently oversees increasingly complex and international industries and markets with modest staff and limited resources, operating in conjunction with the states and self-regulatory organizations. While this cooperative structure enables the Commission to leverage its resources to fulfill its missions, leverage can only go so far. The SEC needs full funding for pay parity in fiscal 2003 and more personnel immediately. In addition, we are continuing to evaluate our staffing and other resource needs through our agency-wide resource assessment which will conclude at the end of July.

We are confident that with these additional resources, the SEC will have the capacity and personnel to ensure that our markets remain the envy of the world and are as fair and transparent to all investors as we can possibly make them. Thank you for the opportunity to testify today. I am pleased to respond to any questions the Subcommittee may have.

APPENDIX A

Summary of the SEC's Actions Taken Under Title 5

The recruiting and retention problems the Commission faces are not new, nor are the Commission's attempts to remedy them. Indeed, the Commission has worked diligently over the last several years to take advantage of the existing flexibilities available under its current pay schedule that exists under Title 5. In particular, the SEC has gained special rate pay authority on two different occasions; used recruitment bonuses, retention allowances, and superior qualifications appointments; and undertaken various quality of life efforts. In addition, in 1998, the Commission received the authority under the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), to increase the salary levels that it can pay its economists. While some of these efforts have provided temporary relief for the Commission, none has resolved the Commission's need for permanent, systemic pay relief. The Commission's experience with these various tools is as follows:

Special Pay. In 1992, the SEC obtained the authority from the OPM to pay staff attorneys and accountants with at least two years of securities industry experience special pay rates at approximately ten percent above base pay. Over the short term, this grant of authority did reduce the Commission's recruitment and retention problem, although our turnover rates still remained above the government-wide averages. However, its effectiveness was eroded quickly with the implementation of annual government-wide locality pay increases. In 1994, locality pay became available and the special pay differential began to disappear because employees receiving the special rates cannot, by OPM regulation, receive locality pay raises each year.

The SEC's fiscal 2001 budget also included funds to reinstate a special pay differential for securities industry attorneys and accountants, and added the differential for experienced securities compliance examiners. New special pay rates were approved by OPM in March 2001. While we believe these rates contributed to reduced staff turnover in fiscal 2001, they were less than the differential between the SEC and the other federal financial regulators and again are subject to the locality pay erosion.

Recruitment Bonuses. Since 1992, we have provided over 245 recruitment bonuses averaging 10 percent of base pay. Over 180 (74 percent) of these bonuses have been provided within the last one and one half years, as our difficulty in attracting key staff has increased dramatically. Recruitment bonuses, by their nature, are one-time payments that do not address the serious structural problems with the Commission's salary scale.

Superior Qualifications Appointments. In fiscal 2000 and 2001, most of our attorney, accountant, and compliance examiner hires were appointed at higher than Step 1 of their grade as the only way we could attract these high quality candidates to the SEC. However, such appointments mean that these individuals will now run more quickly into in-grade pay ceilings that are significantly lower than those at the banking agencies.

Retention Allowances. Since 1993, over 120 employees have received retention allowances. Currently, 53 employees receive allowances that range from 3 to 25 percent of their base pay. In fiscal 1999, three employees receiving retention allowances left the SEC; in fiscal 2000, ten employees receiving retention allowances left the agency; and in fiscal 2001 seven employees receiving retention allowances left the agency. Like recruitment bonuses, these payments are merely stopgap measures that do not address the structural, long-term problems with the Commission's uncompetitive pay scale.

Economist Special Pay. Although SLUSA granted the Commission authority to pay higher salaries to certain economists than those permitted under Title 5, this authority was capped at levels significantly lower than those at which the banking agencies pay their economists. Even with this limitation, however, higher pay has slowed economist attrition at the SEC. Since 2000, when the new pay scale went into effect, the SEC has had a net gain of eight economists. The economist pay provisions of SLUSA were repealed by the pay parity legislation.

Transportation Benefits. In 1993, the SEC began providing transportation subsidies of $21 per month to eligible staff in an effort to encourage them to use public transportation. The SEC increased the subsidy to $42 per month in 1999, and further raised it to $65 per month in 2000. Approximately two-thirds of the staff currently receive the transportation benefit. We believe this benefit has not had an appreciable affect on the length of time that employees choose to stay with the Commission, as it is translates into a very small benefit for the average mid-level professional.

Compressed Work Schedules. The SEC has allowed staff to request alternate work schedules for many years. During the past five years, pilot compressed work schedules following the "5-4-9" model have been implemented in certain SEC offices. In February 2001, a "5-4-9" pilot program was introduced for the entire agency. The SEC currently is negotiating a contract with its employee union that will, among other things, address alternative work schedules.

Fitness Center. The SEC's Headquarters fitness center opened in 1992. Approximately 475 employees currently are members of the Headquarters fitness center and 100 employees belong to the center at our Operations Center, paying only a small monthly fee. The fitness center also sponsors wellness programs for all employees. However, to our knowledge, two of the banking agencies, and possibly more, provide a comparable fitness facility and programs at less cost to most users.

Emergency Child Care. In 1999, the SEC made arrangements with a contractor to provide emergency child care for employees in several locations.

Critical Pay. Current law allows certain "critical personnel" to be paid at rates up to that paid to the Vice President. Government-wide, this authority is colloquially referred to as the "Nobel Laureate" provision because an employee essentially needs to be of Nobel Laureate caliber to be approved for critical pay by OPM. No more than a handful of employees currently receive this level of pay across the entire government, and none of them works for the Commission. As such, and after various discussions with OPM regarding this authority, this is not a tool that the SEC has attempted to employ.

Pay Banding. The Commission has not implemented pay banding. Implementing such a system would provide more flexibility to reward outstanding performers, but only up to the pay levels at the top of the band. Many of our staff already are being paid close to the ceiling of what we would be able to give them under a pay banding system. Therefore, this would be at best a partial solution that fails to address the main problem, leaving our top performers well short of the pay of their counterparts at the banking agencies.

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[1] Please see Appendix A for a summary of these efforts.

Committee Members | Subcommittees | Hearings | Key Legislation | Jurisdiction
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