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Self-Funding for the Securities and Exchange Commission

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SELF-FUNDING FOR THE SECURITIES AND EXCHANGE COMMISSION

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What is the most important issue in effective securities regulation that was not addressed by the Sarbanes-Oxley Act of 2002? In my opinion, it is the issue of self-funding for the Securities and Exchange Commission ("SEC" or "Commission"). The experience of the SEC in the years immediately preceding the Sarbanes-Oxley Act was one of an agency substantially underfinanced by Congress with a staff inadequate to fully perform such core functions as review of required filings.

This dysfunction was the result of the inability of the Commission to effectively secure appropriations to match its staff needs for the regulatory problems it was established to address. From the perspective of the White House and Congress, the SEC was just another agency. Its staff and budget requirements were consolidated with those of other agencies, and its rate of budgetary and staff adjustments were similar in significant aspects to the Executive Branch as a whole. Congress did not have the ability to focus on the precise regulatory dynamics of an agency like the SEC, to distinguish its needs from those of other agencies, and to address them in a timely fashion.

The Commission is subject to a somewhat unique further type of budgetary dynamic. Its need for a larger staff tends to increase during market surges. It is exactly when stock prices are climbing that support for effective securities regulation is likely to decrease. It is also exactly during market surges that an adequately staffed SEC could most effectively deter securities fraud which tends to burgeon after periods of an inadequately funded SEC.

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This essay attempts to illustrate through recent historical experience the need for a new approach to SEC funding. It should be read with two caveats.

First, the case for agency self-funding can be persuasively articulated only if one accepts the need for independent regulatory agencies. Agency independence is a debatable proposition, but I do believe that the preference for an independent SEC is also validated by historical experience.

Second, I do not believe that SEC self-funding will be an easy proposal for Congress to adopt. Congress generally prefers control of budgetary purse strings as a technique to control how the independent regulatory agencies function. It is a crude technique. If there is one clear lesson from the SEC's recent history it is that a new approach to the Commission's budget should be a priority because the costs of delayed adequate SEC staff are so damaging to our economy.

I. THE INDEPENDENT REGULATORY AGENCIES GENERALLY

The genius of the United States Constitution was to popularize a tripartite separation of legislative, executive, and judicial power as a means to limit the power of the executive. As a technique for dispersing potential autocracy, our Constitution has generally succeeded.

As a technique for governance of complex social phenomena, by the late nineteenth century, the Constitution's tripartite model was inadequate. In 1932, just before the New Deal, Felix Frankfurter, then a Professor at Harvard Law School, wrote in the preface to one of the earliest administrative law casebooks, about "the distinctive development of our era:"

> Governmental regulation of banking, insurance, public utilities, industry, finance, immigration, the professions, health and morals, in short, the inevitable response of government to the needs of modern society, is building up a body of enactments not written by legislatures and of adjudications not made by courts, and only to a limited degree subject to their revisions. These powers are lodged in vast congeries of agencies. We are in the midst of a process, still largely unconscious and unscientific, of adjusting the play of these powers to the traditional system of Anglo-American law and courts.[1]

In retrospect, it is obvious that the emergence of "vast congeries of agencies" is among the most fundamental transformations to have occurred in twentieth century American governance. Today, it is commonplace to assume that most routine Executive Branch decisions will be made by the

1. JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 59 (1982).

administrative agencies. Administrative agencies can be divided between those that are housed within Cabinet departments such as the Internal Revenue Service, which is part of the Treasury Department, and those that are more formally independent of the White House such as the Federal Reserve System, Consumer Product Safety Commission, Federal Trade Commission, and the SEC.

James Landis, one of the drafters of the initial federal securities laws, was responsible for the most memorable amplification of Frankfurter's view of government-by-independent administrative agency.[2] In 1938, responding to criticism that the independent administrative agencies had become "a headless fourth branch of the government, a haphazard deposit of irresponsible agencies and uncoordinated powers."[3] Landis defended the administrative process as "the most significant development in legal history in the last century,"[4] essentially because of "the inadequacy of a simple tripartite form of government to deal with modern problems."[5] In Landis's view, only the administrative agencies could "provide for the efficient functioning of the economic processes of the state."[6] Legislation was "forced to represent compromise,"[7] and often "does so by the use of vague phraseology."[8] The Judiciary had a broad general jurisdiction, depriving it of the ability "to maintain a long-time uninterrupted interest in a relatively narrow and carefully defined area of economic and social activity."[9] Neither branch could regulate industry as effectively as the administrators of an agency with a specific function.[10]

"As Landis put it: 'With the rise of regulation, the need for expertness became dominant; for the art of regulating an industry requires knowledge of the details of its operations, ability to shift requirements as the condition of the industry may dictate.'"[11]

> Disparaging legislation that attempted to prescribe in too great detail "the conditions of administrative action," and administrators who took "the legislative approach" of reading "a governing statute with the hope of finding limitations upon authority," Landis argued that the appropriate re-

2. *Id.* at 61–62.
3. *Id.* at 62.
4. *Id.*
5. *Id.*
6. SELIGMAN, *supra* note 1, at 62.
7. *Id.*
8. *Id.*
9. *Id.*
10. *Id.*
11. SELIGMAN, *supra* note 1, at 62 (quoting JAMES M. LANDIS, THE ADMINISTRATIVE PROCESS 23–24 (1938)).

> lationship of the democratic legislature to the expert agency was to define the agency's area of expertise and recite the appropriate problems for it to solve, leaving it broad discretion as to means. Exceeding even Frankfurter's faith in administrative experts, Landis would recommend in his seminal work, *The Administrative Process*, greater insulation of the agency from court review and an increase in the sanctions agencies could enforce. He would urge that the "singleness" of an agency's function would lead to "a professionalism of spirit" that would justify its greater independence.[12]

Let us test the Frankfurter-Landis theory with a case study of the SEC.

II. A CASE STUDY: THE SEC

During the period after the New Deal, this nation's system of corporate finance was significantly improved. Long gone are the days when new securities sales were dominated by private investment banks, such as J. P. Morgan and Company, when references to "bear raids" or stock market "pools" appeared daily in the nation's press, when the New York Stock Exchange ("NYSE") fairly could be described as a "private club," and when Senate hearings riveted the nation's attention with revelations of fraudulent Peruvian bond sales, "preferred" stockholder lists, bribed journalists who "touted" securities, or stock price manipulation. Gone too are the public utility holding companies, the least justifiable corporate structure to evolve during the 1920s' "bull" market, "blank" corporate proxies, and the time when securities fraud usually was irremediable because of the deficiencies of state corporate law. In 1975, fixed minimum commission rates, a way of life on the NYSE since 1792, were abolished.

The principal actor in this transformation of corporate finance was the SEC. During and immediately after the New Deal period, the SEC earned the reputation as one of the most ably administered federal independent regulatory agencies, principally because of the competence of the Commission's staff, the agency's role in restoring confidence in the safety of securities investment in the 1935-1937 period, the SEC's 1937-1938 reorganization of the NYSE's governance, and the Commission's enforcement of the geographic integration and corporate simplification provisions of the Public Utility Holding Company Act.

The SEC's performance after World War II, by contrast, has been frequently criticized. Although the quality of the Commission's staff and its enforcement and mandatory disclosure programs have generally received high marks, the SEC's caution in challenging the NYSE's fixed commission

12. *Id.*

rates and anticompetitive rules early in the 1970s was severely criticized by Congress, the Justice Department, and independent commentators. More recently, the SEC was criticized for the slow pace with which it facilitated the creation of a competitive national market system and its oversight of accounting standard setting and corporate governance.

The latter critique of the Commission intensified during the past decade. Consider what is generally regarded as the successful chairmanship of Arthur Levitt between 1993 and 2001, to highlight recent stresses on the agency.

In the last years of the 20th Century, the United States securities markets experienced an almost unimaginable growth and vitality. When the stock market began its collapse in September 1929, the aggregate value of all shares on the NYSE was approximately $90 billion.[13] By 2000, NYSE capitalization had grown to nearly $12.4 trillion.[14] Remarkably in 2000, over $2.3 trillion in new securities were sold in some 16,481 corporate underwritings and 3,540 private placements.[15]

Underlying this almost unimaginable growth was the longest sustained bull market in United States history. Focusing on year end closing indexes, the Dow Jones Industrial Average rose from 875 in 1981 to 11,497 in 1999, paralleling similar surges in other leading composite indexes.[16] To put this in different terms, between 1981 and 1999, the NYSE stock market capitalization increased nearly eleven fold from $1.1 to $12.3 trillion.[17]

During the boom years of this great bull market, Arthur Levitt served as SEC Chair.[18] It was a period of near boundless ebullience. Early in his chairmanship, Levitt began a speech: "Just before the S.E.C.'s creation in 1934, the Dow Jones Industrial Average hit an all-time low of forty-one points. In 1994, it hit an all-time high of 3,978.36."[19] By 1997, he would observe, "[i]n the past year, the Dow Jones Industrial Average has broken 5,000, 6,000 and 7,000 point[] [levels]."[20] As in the 1920's, references were made to "The New Economy" as well as to the Dot.com boom.[21]

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13. *Id.* at 1.
14. SEC. INDUS. ASS'N, SEC. IND. FACT BOOK 48 (2001).
15. *Id.* at 12.
16. *Id.* at 54.
17. *Id.* at 48.
18. *See* Jake Ulick, *Year of the Scandal 2002: Greed, Accounting Conflicts, Book-cooking Helped Derail Wall Street. Will 2003 be Any Better?*, CNN MONEY, Dec. 17, 2002, *at* http://money.cnn.com/2002/12/17/news/review_scandals/.
19. Arthur Levitt, Remarks at the Public Securities Association Annual Meeting (Mar. 4, 1994).
20. *Departments of Commerce, Justice, and State, the Judiciary, and Related Agencies Appropriations for Fiscal Year 1998: Hearings on H.R .2267 and S. 1022 Before a Senate*

A core issue during the Levitt Chairmanship was resources. During the first Bush administration, Fiscal Years ("FY") 1989-1993, the Commission budget grew from $142.6 million to $253.2 million, an average of 19% per year;[22] its staff from 2,604 positions to 3,083 or an average of 4.6% per year.[23] This was a significant achievement for the Breeden SEC.[24]

Growth during the Levitt chairmanship was considerably slower. Between FY 1993 and FY 2000, the SEC budget grew from $253.2 million to $382.4 million or an average of 6% per year.[25] Staff positions grew from 3,083 to 3,235 or an average of less than 1% per year.[26] During the 1990s' bull market, virtually every significant measure of securities activity grew far faster. Between 1993 and 2000, for example, the dollar value of securities filed for registration grew from $868 billion to $2.3 trillion,[27] an average increase of 24% per year; the number of underwritten securities more than doubled in the shorter period of 1993 to 1999 (increasing from 6,443 to 13,923).[28] Similarly, the dollar value of investment companies grew from $2.4 trillion in 1993 to $6.7 trillion in 2002,[29] an average annual increase of 21.3% per year; the number of investment company portfolios grew from 21,200 to 31,100 during the same period, an average annual increase of 5.1% per year.[30] "In calendar year 1992, the [SEC] supervised over 8,200 broker-dealers with 34,000 branch offices and 427,000 registered representatives . . . ."[31] By 2001, the number of registered broker-dealers had declined to 7,900, but the number of branch offices had increased to 87,765 (an average annual increase of 17.6%) and the number of registered representatives had grown to 683,240 (an average annual increase of 6.7%).[32] The value of stock listed on all exchanges approximately tripled between 1992 and 2000 (increasing from $3.97 trillion to $11.73 trillion).[33]

Subcomm. of the Comm. on Appropriations, 105th Cong. 212 (1997) (statement of Arthur Levitt, Chairman, SEC) [hereinafter *Appropriations for 1998*].

21. *Id.*

22. Fran Hawthorne, *Memo to Arthur Levitt, Rose Petals Today*, INSTITUTIONAL INVESTOR, Aug. 1993, at 55, 56.

23. 1993 SEC ANN. REP. 150.

24. Hawthorne, *supra* note 22, at 55.

25. 1993 SEC ANN. REP. 80; 2000 SEC ANN. REP. 159.

26. 1993 SEC ANN. REP. 150; 2000 SEC ANN. REP. 159.

27. *Compare* 1993 SEC ANN. REP. 51, *with* 2000 SEC ANN. REP. 70.

28. SEC. INDUS. ASS'N., *supra* note 14, at 12.

29. *Compare* 1993 SEC ANN. REP. 38, *with* 2002 SEC ANN. REP. 53.

30. *Id.*

31. 1993 SEC ANN. REP. 24.

32. 2001 SEC ANN. REP. 34.

33. 2001 SEC ANN. REP. 169.

Throughout this period, fees collected by the SEC far exceeded its annual appropriations. In 1993, for example, total fee collections of $517 million represented "204 percent of the Agency's appropriated spending authority of $253 million."[34] By 2001, the SEC deposited $2.06 billion in the United States Treasury or 539% of the Agency's $382.4 million budget.[35]

Neither the Clinton Administration nor Congress gave the SEC adequate budgetary or staff support during Levitt's Chairmanship.

As a general matter, the Clinton White House was little concerned with the SEC. With the exception of the Gramm-Leach-Bliley Act of 1999,[36] which primarily addressed banks, the Clinton White House exhibited little interest in securities legislation. To be sure, the Clinton White House rarely questioned an SEC decision during Levitt's chairmanship. But what the Clinton Administration appeared most to want was a sufficiently well run SEC so that it would not require White House attention.

Before Levitt was confirmed, President Clinton's FY 1994 budget called for a reduction of forty-two positions in the Commission budget.[37] With a few exceptions, Clinton's appointments to the SEC, other than Levitt, were undistinguished, often appointed for transparently political reasons, rather than their qualifications to be a commissioner. For sustained periods during the Clinton administration, only two or three commissioners in fact were in office.[38] Indeed, in 1995, the Commission took the unprecedented step of adopting a quorum rule to provide that if the number of commissioners in office was as few as two or one, that number would be sufficient for a quorum.[39] The senior staff appointed by Levitt was consistently stronger with outstanding division directors or general counsel such as William McLucas, Linda Quinn, Richard Walker, and Harvey Goldschmid.

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34. 1993 SEC ANN. REP. 80.

35. 2001 SEC ANN. REP. 119.

36. 12 U.S.C. § 1811 (2000).

37. John M. Doyle, *Clinton Budget Plan Calls for SEC to Cut 42 Posts; Move May Imperil Probes*, BOSTON GLOBE, Apr. 10, 1993, *available at* http://nl.newsbank.com/nl-search/we/Archives?p_product=BG&p_theme=bg&p_action=search&p_maxdocs=200&p_text_search0="Clinton%20Budget%20Plan%20Calls%20For%20SEC"&s_dispstring=Clinton%20Budget%20Plan%20Calls%20For%20SEC%20AND%20date(4/1/1993%20to%204/30/1993)&p_field_date-0=YMD_date&p_params_date-0=date:B,E&p_text_date-0=4/1/1993%20to%204/30/1993&p_perpage=10&p_sort=YMD_date:D&xcal_useweights=n.

38. *See* U.S. SEC, HISTORICAL SUMMARY, *at* http://www.sec.gov/about/concise.shtml #history (last visited Oct. 24, 2003).

39. Establishment of Commission Quorum Requirement, Exchange Act Release No. 34-35548, (Mar. 30, 1995) (codified at 17 C.F.R. pt. 200 (1995)). In 1996, the District of Columbia Circuit Court held that the quorum rule was validly adopted. Falcon Trading Group, Ltd. v. SEC, 102 F.3d 579, 582 (D.C. Cir. 1996) (citing La Peyre v. FTC, 366 F.2d 117, 122 (5th Cir. 1966)).

Each year Levitt's Congressional testimony on the budget was an exercise in frustration, or, at best, damage control. On July 29, 1993, two days after being sworn in, Levitt testified to the Senate Securities Subcommittee:

> [t]he Commission has an urgent need for additional resources to conduct examinations and perform an oversight function for investment advisers and investment companies. Between 1981 and 1993, the number of registered advisers increased from 5,100 to more than 18,000, and assets managed by investment advisers rose from $450 billion to over $9 trillion. Staff resources have lagged so far behind this phenomenal growth that the Commission is currently able to inspect some advisers only once every thirty years.
>
> A resource need also exists for inspections of investment companies. We are able currently to perform limited annual inspections of money market funds, funds in the 100 largest fund complexes, and some small fund complexes. A growing number of new fund complexes, including many that recently have been organized by banks, have not been inspected, except for their money market funds.[40]

Levitt sought, and was that year denied, resources "to add almost 200 examiners to its staff, which would significantly enhance our inspection program by reducing the lengthy inspection cycle. In addition, our authorization request, if approved, would provide the Commission with much-needed resources to shorten the inspection cycle for investment companies."[41]

In November 1993, Levitt testified in favor of self-funding as a means to resolve the problem of insufficient staff: "To ensure that the Commission has adequate resources it must be self-funded. Under a self-funding arrangement known as full-cost recovery, the Commission would be authorized to use filing and transaction fee collections to fund all agency operations instead of using annual appropriated funds."[42] Levitt took pains to "emphasize that self-funding would not remove the Commission from Congressional oversight."[43] Whether because of Congressional concern on this point or a more generalized unwillingness to support a better funded SEC, full Commission self-funding was not approved at any time during Levitt's Chair-

40. *Concerning the Commission's Authorization for Fiscal Years 1994–1995: Hearing Before the Senate Subcomm. on Sec., Senate Comm. on Banking, Hous. & Urban Affairs*, 103rd Cong. 2–3 (1993) (opening statement of Arthur Levitt, Chairman, SEC).

41. *Id.* at 3.

42. *Oversight Hearing on the Mutual Fund Industry: Hearing Before the Senate Subcomm. on Secs. of the Comm. on Banking, Hous. & Urban Affairs*, 103d Cong. 62 (1993) (statement of Arthur Levitt, Chairman, SEC).

43. *Id.*

manship.[44] In retrospect, Levitt would term the self-funding initiative "naive." "Congress was unwilling to give up the pursestrings," he would explain in an interview with the author.

After the 1994 Congressional elections, budget appropriations for the Commission became more difficult. Soon after the new Congress was convened, an effort was led by the Senate Governmental Affairs Committee to halt the effectiveness of all new federal rules, including SEC rules, adopted between November 9, 1994 and June 30, 1995.[45] The rule moratorium subsequently was not pursued because of concerns it would wreak havoc with

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44. 1994 SEC ANN. REP. 76. The 1994 SEC Annual Report described the strange fate of the Commission's 1994-1995 authorizations:

> In 1993, the House passed an SEC authorization bill for 1994-95, which contained a provision for SEC self-funding. Senate budgetary rules, and the opposition of some Senators to the concept of SEC self-funding, prevented the Senate from taking comparable action. The SEC's fiscal 1995 appropriation, which relied on a form of self-funding to offset the SEC's appropriation, was supported by the SEC's appropriations subcommittees but ultimately fell to disagreements over SEC fees and self-funding generally. As a result of these disagreements, Congress passed a stopgap SEC appropriation bill in August 1994 providing only $125 million (Pub. L. No. 103-317), with the intention of revisiting the issue of SEC funding and passing a supplemental appropriations bill within five months. OMB determined, however, that applicable federal law required the SEC to apportion that partial appropriation as if it were the full appropriation for the fiscal year. Consequently, the SEC faced a budget shortfall of approximately $172 million and the possibility of severe curtailment of operations.
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> Due to jurisdictional disputes in the House, the availability of an additional SEC appropriation was conditioned on the enactment of separate revenue legislation, raising SEC registration fees, that would offset the SEC's additional appropriation. Thus, to fund the SEC fully, it was necessary for Congress to pass two separate pieces of legislation in the two month period before the end of the session—an additional appropriation and a separate revenue bill.
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> The bill providing for an additional SEC appropriation of $192 million was signed into law on September 30, 1994 (Pub. L. No. 103-335). The revenue legislation, H.R. 5060, which set the filing fees under Securities Act Section 6(b) at the rate of 1/29th of one percent, passed the House on September 27, 1994, but was held up in the Senate as various Senators sought to add unrelated provisions to the last major revenue bill of the 103rd Congress. H.R. 5060 finally passed the Senate on October 8, and was signed into law on October 10, 1994 (Pub. L. No. 103-352), thus bringing SEC funding to $297 million. In the early days of fiscal 1995 before the revenue bill's passage, the SEC had to curtail inspections, enforcement activity, and other "non-essential" services.

Id. See also Senate Hearings: Hearing on H.R. 4603 Before the Subcomm. of Commerce, Justice, and State, the Judiciary, and Related Agencies Appropriations of the Comm. on Appropriations, 103d Cong. 887 (1995) (opening statement of Arthur Levitt, Chairman, SEC).

45. Lynn Stevens Hume, *GOP Senators May Be Giving up on Regulatory Moratorium Bill*, THE BOND BUYER, Mar. 20, 1995, at 2.

regulatory agencies.[46] But approximately the same time House Commerce Committee Chair Thomas Bliley and others negotiated an agreement with the SEC to reduce the fees paid to the United States Treasury for new securities offerings.[47] By the summer of 1995, new legislation had been introduced to redefine the Commission's mission, freeze the SEC budget for five years, and reduce the number of SEC Commissioners from five to three.[48] In July 1995, Bliley deputized Congressman Frisa to conduct a "top to bottom review" of SEC operations with the aim of "cutting all regulatory deadwood."[49]

Levitt attempted to defuse the deregulatory enthusiasm. Within a few months he appointed Phillip K. Howard, author of a book critical of federal regulation entitled *The Death of Common Sense* to chair a commission task force on disclosure simplification.[50] In 1996, the Task Force recommended the elimination of a total of eighty-one Commission rules and twenty-two forms, as well as the modification of "dozens of others."[51]

Levitt tentatively embraced several Task Force proposals, starting on March 5, 1996; that he found especially promising: 1) An investor-friendly prospectus, whose cover page and first few pages would be written in plain English, as opposed to the usual boilerplate-laden prose;[52] 2) A "profile" tender offer summary that brings together the most important information, saving potential investors from having to hunt through the entire document;[53] 3) The federal government would get even further out of the way of small offerings to local areas, leaving primary oversight to state and local authorities; 4) Small businesses would be able to raise twice as much money as they can today under Regulation A—$5 million every six months rather than every year.[54]

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46. *Id.*

47. Jeffrey Taylor, *Republicans Reach Accord with SEC to Reduce Fees*, WALL ST. J., June 30, 1995, at B12. The fee reduction legislation, later further amended, is codified in section 6(b) of the Securities Act of 1933 and section 31 of the Securities Exchange Act of 1934. *See generally* Securities Act of 1933 § 6(b), *at* http://www.law.uc.edu/CCL/33Act/sec6.html; Securities Exchange Act of 1934 § 31, 15 U.S.C. 78c (2000).

48. Michael Schroeder, *Guess Who's Gunning for the SEC*, BUS. WK., Aug. 14, 1995, at 40.

49. *Id.*

50. Mark H. Anderson, *SEC Task Force is Seeking Ways to Ease Regulations on Business*, WALL ST. J., Sept. 1, 1995, at A3, *available at* 1995 WL-WSJ 9898303.

51. Report on Disclosure Simplification, [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,738 (Mar. 5, 1996).

52. *Id.*

53. *Id.*

54. *Id.*

In 1996 and 1997, the Commission adopted several Task Force recommendations.[55] Cumulatively the changes that the Commission made eliminated or modified a number of marginal aspects of the earlier adopted integrated disclosure system. The basic system remained largely intact. But the political implication of this Task Force was clear. The Commission would have to backpedal by administrative action to reduce the likelihood of more deregulatory legislation. Levitt's business background made the backpedaling appear less contrived to those favoring deregulation.

Nearly simultaneously, Levitt appointed Commissioner Steven Wallman to Chair a Commission Advisory Committee on Capital Formation and Regulatory Processes.[56] Levitt and Wallman had a complex relationship and the motivation for the appointment of this Committee also involved Levitt's desire to find a significant project for Wallman.

The Wallman Committee Report later also sounded deregulatory themes, most significantly proposing that the Commission go further than the earlier adopted integrated disclosure system to adopt a system of company registration for companies issuing securities.[57] This proposal was primarily intended to remove unnecessary costs and restrictions on issuer access to capital while also enhancing investor protection through improvements in the disclosure process.[58]

These near simultaneous initiatives may have strengthened Levitt's hand in what was a particularly difficult budget cycle. In September 1995, the Senate Appropriations Committee approved a bill cutting the Commission's budget by 20% to $237 million for FY 1996, after the full House had adopted a bill to freeze the Commission budget at $297 million.[59] The Senate also voted to abolish altogether the Commission's Office of Investor Education and Assistance.[60]

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55. Phase One Recommendations of Task Force on Disclosure Simplification, Securities Act Release No. 7300, 62 SEC Docket 75 (May 31, 1996); Phase Two Recommendations of Task Force on Disclosure Simplification, Securities Act Release No. 7431, 62 SEC Docket 2 (July 18, 1997). *See generally* 2 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 624–27 (3d ed. rev. 1999).

56. Report of the Advisory Comm. on the Capital Formation and Regulatory Processes, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,834 (July 24, 1996).

57. Securities Act Concepts and Their Effects on Capital Formation, Securities Act Release No. 7314, 62 SEC Docket 1046, 1048 (July 25, 1996).

58. *See generally* 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 391–98 (3d ed. rev. 1998).

59. Lynn S. Hume, *Democrats Blast Senate Panel's Proposed SEC Funding Cuts*, BOND BUYER, Sept. 27, 1995, at 3.

60. *Cutting the Securities Cops*, WASH. POST, Oct. 15, 1995, at C6.

Title IV of the National Securities Markets Improvement Act ("NSMIA") of 1996 soon reduced SEC fee collections over a ten-year period to better align fee collections with the funding needs of the Commission.[61] NSMIA, notably, however, did not simultaneously adopt the type of self-funding that Levitt earlier and later characterized as vital to the effective functioning of the Commission.[62]

The Commission ultimately did receive a FY 1996 budget of $301 million (including $4 million in prior year carryover funds) with no increase in staff positions.[63] For FY 1997, Levitt began his budget testimony by almost wistfully noting that when the Commission had last submitted an authorization request in June 1994 covering FY 1995-1997, the Agency had sought $382.7 million for FY 1997.[64] In February 1996, Levitt sought an authorization of $317 million for FY 1997,[65] which, in May 1996, Levitt testified that the President requested be reduced to $308.2 million as part of a "'no growth' budget."[66] Congress ultimately approved $305.4 million for FY 1997, which, when combined with prior year carryover funds of $5.7 million equaled $311.1 million, and again meant no increase in staff.[67]

To achieve this funding level, Levitt characterized the SEC "as reinvent[ing] itself . . . continually [searching] out new ways of regulating more effectively but less intrusively, and at a [lower] cost to industry and investors."[68] Among other steps, the Commission raised the total asset threshold for registrants to be subject to the Security Exchange Act from $5 million to $10 million,[69] reducing the number of companies subject to registration requirement of that Act.

For FY 1998, President Clinton again directed the SEC to seek a "no-growth" budget with respect to staffing levels and a $12 million larger ap-

61. *Fees Collected Under the Securities Act of 1933: Hearing Before the Senate Subcomm. on Secs. of the Comm. on Senate Banking, Hous. and Urban Affairs*, 106th Cong. 3 (1999) (statement of Arthur Levitt, Chairman, SEC).

62. *Id.*

63. *The Securities and Exchange Commission Reauthorization Act of 1996: Hearing on H.R. 2972 Before the Subcomm. on Telecomms. & Fin. of the Comm. on Commerce*, 104th Cong. 10 n.1 (1996) (statement of Arthur Levitt, Chairman, SEC) [hereinafter *SEC Reauthorization Act of 1996*]; 1996 SEC ANN. REP. 213.

64. *The SEC Reauthorization Act of 1996, supra* note 63, at 10 n.1.

65. *Id.* at 10.

66. *Concerning Appropriations for Fiscal Year 1997: Hearings Before the Subcomm. on Commerce, Justice, and State, the Judiciary, and Related Agencies of the House Comm. on Appropriations*, 104th Cong. 207 (1996) (testimony of Arthur Levitt, Chairman, SEC).

67. 1997 SEC ANN. REP. 208.

68. *SEC Reauthorization Act of 1996, supra* note 63, at 6.

69. Relief from Reporting by Small Issuers, Securities Act Release No. 34-37157, 61 SEC Docket 2092 (May 1, 1996).

propriation overall, most of which "would go to mandatory increases in pay and related personnel benefits."[70] For the fourth consecutive year the ultimate Congressional appropriation froze staff positions.[71]

By March 1998, when Levitt testified about the FY 1999 budget, the presidential and congressional parsimony was beginning to have serious implications for the Commission's ability to perform its core mission. Levitt testified: "Between 1980 and 1994, the number of SEC authorized positions increased 35%. To put that in perspective, for the same period assets under management of Investment companies and Investment advisers increased 964% and 2082%, respectively. However, since 1995, authorized positions have been flat."[72]

> Levitt noted with particular concern:
>
> In fiscal 1997, turnover at the SEC increased dramatically, especially in our three major program occupations (attorneys, accountants, and securities compliance examiners). For example, the SEC's overall turnover rate in fiscal 1997 was 11.9% compared to 9.5% in fiscal 1996. The 1997 turnover rate for attorneys was 16% compared to 11.3% in 1996. The 1997 turnover rate for accountants . . . was 12.1% compared to 9%, and for examiners the rate was 10.8% compared to 10.3%. By comparison, government-wide white collar turnover has been in the range of 7-8% a year for the last couple of fiscal years.[73]

The Clinton FY 1999 budget request sought an increase of $26.1 million and thirty new staff positions above the SEC's 1998 appropriation.[74] Congress ultimately approved a budget that added sixty-two positions and $36 million to the FY 1999 appropriation.[75]

In retrospect, it is clear that the FY 1999 increase was too little, too late. As early as 1998, newspapers were publishing articles with headlines such as "SEC Turnover Rate Leaves Agency Scrambling in Fight against Fraud."[76] Or as a May 1998 article put it: "Ten Things the SEC Won't Tell You:

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70. *Appropriations for 1998*, *supra* note 20, at 212.

71. 1998 SEC ANN. REP. 176.

72. *Departments of Commerce, Justice, and State, the Judiciary, and Related Agencies Appropriations for 1999: Hearings Before a Senate Subcomm. on Appropriations*, 105th Cong. 296, 305 (1998) (testimony of Arthur Levitt, Chairman, SEC).

73. *Id.* at 311.

74. *Id.* at 293.

75. 1999 SEC ANN. REP. 197.

76. Michael Schroeder, *SEC Turnover Rate Leaves Agency Scrambling in Fight against Fraud*, WALL ST. J., Oct. 23, 1998, at B6.

Number 1: 'We're overwhelmed.'"[77] In 1998, in a move unprecedented at the Commission, a growing number of the staff began to explore unionization as a response to increased uncompensated extra hours, known as "'donated' time"[78] and low pay.[79] By a greater than two to one vote, unionization was approved in 2000 for 1800 non-management SEC lawyers, accountants, and support workers.[80] This symbolized a low point in staff morale, largely a response to the inadequate budgets approved by Congress and the inability of the Clinton administration to effectively address a growing problem that persisted year after year. Levitt would explain in an interview with the author that he regarded unionization as a personal failure.

President Clinton and Congress supported a staff increase in FY 2000 of 134 positions (4.2%) and a budget increase of $26.3 million.[81] In FY 2001, Clinton and Congress supported a staff increase of fifty positions (1.5%) and a budget increase of $44.9 million.[82]

Levitt repeatedly testified to the urgency of a considerably broader effort to staunch the growing inability of the Commission to effectively perform its core functions. In February 2000, for example, he asserted: "The SEC is in the midst of a serious staffing crisis . . . . In the last two years, the Commission has lost 25% of its attorneys, accountants, and examiners."[83] After detailing threats to "our ability to oversee the nation's securities markets and to respond in a timely manner to the changing events . . . in our markets,"[84] Levitt urged that SEC salary levels should be at the same levels as those in the banking regulatory agencies such as the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (popularly known as "pay parity"), a salary increase of roughly

77. Robinson G. Clark, *Ten Things the SEC Won't Tell You*, SMART MONEY, May 1, 1999, at 147.

78. Cindy Skrzycki, *The Regulators: Unionization Vote Grows Out of SEC's Culture*, WASH. POST, June 4, 1999, at E1.

79. Michael Schroeder, *SEC Immersed in Testy Effort by Employees to Unionize*, WALL ST. J., Aug. 16, 1999, at C1; Cindy Skrzycki, *The Regulators; At SEC Skies are Suddenly Sunnier*, WASH. POST., Jan. 21, 2000, at E1.

80. *S.E.C. Workers Vote for Union*, N.Y. TIMES, July 18, 2000, at C7.

81. 2000 SEC ANN. REP. 159.

82. 2001 SEC ANN. REP. 171.

83. *Departments of Commerce, Justice, and State, the Judiciary, and Related Agencies Appropriations for Fiscal Year 2001: Hearings on H.R. 4690 Before the Senate Subcomm. of the Comm. on Appropriations*, 106th Cong. 326 (2000) (testimony of Arthur Levitt, Chairman, SEC) [hereinafter *Appropriations for 2001*]; *see also The Competitive Market Supervision Act: Hearing on S. 2107 Before the Senate Comm. on Banking, Hous. and Urban Affairs*, 106th Cong. 7, 39–40 (2000) (statement of Arthur Levitt, Chairman, SEC) [hereinafter *Competitive Market*].

84. *Competitive Market*, *supra* note 83, at 7.

24 to 39%.[85] In Levitt's view, pay parity would improve staff morale and lengthen the service time of the most talented entry level staff to "a minimum of three to five years."[86] Levitt estimated that pay parity then would have cost approximately $52 million.[87]

Government Accounting Office ("GAO") reports in 2001 and 2002 provide detailed support for Levitt's complaints. A March 2002 GAO report, *SEC Operations: Increased Workload Creates Challenges*, explained in part:

> SEC and industry officials said [the] SEC's ability to fulfill its mission has become increasingly strained due in part to imbalances between [the] SEC's workload (e.g., filings, complaints, inquiries, investigations, examinations, and inspections) and staff resources . . . . [S]ince 1996 [the] SEC's staff resources have not grown commensurate with its workload. Although industry officials complimented [the] SEC's regulation of the industry given its staff size and budget, both SEC and industry officials identified several challenges [the] SEC faces. First, resource constraints have contributed to substantial delays in the turnaround time for many SEC regulatory and oversight activities, such as approvals for rule filings and exemptive applications. Second, [the] SEC's resource constraints contributed to bottlenecks in the examination and inspection area as workload grew. Third, limited resources have forced [the] SEC to be selective in its enforcement activities and have lengthened the time required to complete certain enforcement investigations . . . . Finally, SEC and industry officials said that [the] SEC has been increasingly challenged in addressing emerging issues, such as the ongoing internationalization of securities markets and technology-driven innovations like ATSs and exchange-traded funds . . . .
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> . . . .
>
> Over the last decade, staffing, within different areas of [the] SEC's regulatory oversight activities, has grown between 9 and 166 percent, while workload measures in those areas have grown from 60 to 264 percent . . . . For example, the number of corporate filings increased 60 percent, while related review staff increased 29 percent. This figure also shows that the number of complaints and inquiries received increased by 100 percent, while the enforcement staff dedicated to investigate complaints and other matters increased by 16 percent. In addition, the number of market and firm supervision actions increased 137 percent, but the number of staff responsible for these activities increased 51 percent . . . .
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> . . . .

85. *Id.* at 41.
86. *Id.*
87. *Id.*

> . . . [A]bout one-third of [the] SEC's staff left the agency from 1998 to 2000. [The] SEC's turnover rate for attorneys, accountants, and examiners averaged 15 percent in 2000, more than twice the rate for comparable positions governmentwide. Although the rate had decreased to 9 percent in 2001, turnover at [the] SEC was still almost twice as high as the rate governmentwide. Further, as a result of this turnover and inability to hire qualified staff quickly enough, about 250 positions remained unfilled in September 2001. SEC officials said that they could do more if they had more staff, but all cited [the] SEC's high turnover rate as a major challenge in managing its workload. Likewise, industry officials agreed that many of the challenges [the] SEC faces today are exacerbated by its high turnover rate, which results in more inexperienced staff and slower, often less efficient, regulatory processes.[88]

The GAO 2001 report concluded earlier, after surveying former and current SEC staff, that they "'overwhelmingly cited low compensation as the primary reason they left or might leave'" the Commission.[89]

What was most significant about the growing imbalance in staff relative to its workload was that it tended to undermine core functions of the Commission, such as review of corporate issuer annual reports by the Division of Corporation Finance, more severely than it reduced the effectiveness of the Commission to pursue new initiatives. In March 2000, for example, Levitt complimented Senator Gregg and the Senate Subcommittee on Commerce, Justice, State, and the Judiciary for their "vital support" in FY 2000 for an additional $7 million appropriation to help fund the SEC's Internet fraud program.[90] Combining this appropriation with the reprogramming of existing budget and staff had permitted the SEC to devote 92 positions to the growing challenge of Internet fraud,[91] as well as traditional areas such as unregistered securities, financial fraud, and insider trading. Indeed, throughout Levitt's Chairmanship, the number of enforcement actions generally rose, averaging 489 enforcement actions initiated per year between 1994 and 2001,[92] compared with 359 per year averaged between 1990 and 1993, roughly the period of the Breeden Chairmanship.[93] Particular attention was

88. GAO, SEC OPERATIONS: INCREASED WORKLOAD CREATES CHALLENGES, GAO-02-302, at 11–13, 25 (Mar. 2002).

89. *Low Pay Cited as Main Reason for Leaving SEC, GAO Says in Recent Report*, 33 SEC. REG. & L. REP. (BNA) 1544 (2001).

90. *Appropriations for 2001*, *supra* note 83; David Wessel, *Internet Mania is Like Lottery, Fed Chief Says*, WALL ST. J., Jan. 29, 1999, at C1. Separately, Federal Reserve Chair Alan Greenspan would bewail the mania for internet-related stocks. *Id.*

91. *Appropriations for 2001*, *supra* note 83.

92. *See* 1997 SEC ANN. REP. 1; 2001 SEC ANN. REP. 1.

93. *See* 1993 SEC ANN. REP. 1.

devoted to "micro cap" and "penny stock" fraud[94] and day trading abuses.[95] Similarly, Levitt created an SEC Year 2000 Task Force which worked effectively with the securities industry to obviate the risks of converting information technology to year 2000 data.[96]

With approximately 3000 staff members throughout the Levitt Chairmanship, the Commission had the capacity to effectively address many of the burgeoning securities industry's regulatory challenges.[97] But it was spread thin and increasingly so in the last years of the Levitt Chairmanship. In October 2002, a staff report of the Senate Governmental Affairs Committee found that in FY 2001, the Division of Corporation Finance was able to complete a full review of only 2,280 of 14,600 Form 10-K annual reports filed by public companies, roughly 16%, far short of the Division's stated goal to review every company's annual report at least once every three years.[98] "Of more than 17,300 public companies, approximately 9,200, or 53%, have not had their Forms 10-K reviewed in the past three years."[99] Enron, then the most notorious example of staff neglect, had last received a partial review of its Form 10-K annual report in 1997 and had been last subject to a full review in 1991.[100]

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94. *Concerning Fraud in the "Micro Cap" Market: Hearing Before the Senate Permanent Subcomm. on Investigations, Comm. on Gov't al Affairs*, 105th Cong. (1997) (testimony of Arthur Levitt, Chairman, SEC).

95. *See generally Day Trading: An Overview: Hearing Before the Senate Permanent Subcomm. on Investigations of the Comm. on Gov't al Affairs*, 106th Cong. 7, 7–8 (1999) (testimony of Arthur Levitt, Chairman, SEC).

96. *Report to the Congress on the Readiness of the United States Securities Industry and Public Companies to Meet the Information Processing Challenges of the Year 2000* (June 1997), *available at* http://www.sec.gov/news/studies/yr2000.htm. *See generally U.S. Financial Institutions and Federal Regulatory Agencies Management of the Year 2000 Computer Problem: Hearings Before the Senate Subcomm. on Finan. Servs. & Tech. of the Comm. on Banking, Hous. and Urban Affairs,* 105th Cong. 59–61 (1997) (opening statement of Arthur Levitt, Chairman, SEC). In all the Commission testified four times in 1997 and 1998 concerning Y2K. *See* 1998 SEC ANN. REP. 89–90. In 1999 the Commission adopted several temporary Y2K rules designed to achieve compliance by the securities industry for mission critical systems. 1999 SEC ANN. REP. 30–32.

97. *See* STAFF OF SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 8 (Comm. Print 2002), *available at* http://news.findlaw.com/hdocs/docs/enron/sensec100702ltr.pdf (last visited Oct. 25, 2003).

98. *Id.* at 11.

99. *Id.*

100. *See id.* at 31–32.

III. REVISITING THE INDEPENDENT REGULATORY AGENCY

An *independent* regulatory agency is a constitutional novelty. It is neither fully part of the executive nor the legislative branch. It is a strikingly vulnerable political actor. Former SEC Chair William Cary well captured this vulnerability when he observed in 1967:

> Government regulatory commissions are often referred to as "independent" agencies, but this cannot be taken at face value by anyone who has ever had any experience in Washington. In fact, government regulatory agencies are stepchildren whose custody is contested by both Congress and the Executive, but without very much affection from either one . . . . Without the cooperation of both Congress and the Executive, little constructive can be achieved. To reemphasize the point, an agency is literally helpless if either branch is uninterested or unwilling to lend support.[101]

It is not inevitable that regulatory agencies be independent, or figuratively, Cary's unloved stepchildren. More consistent with our tripartite separation of powers, "unitary" theorists have urged that all regulatory agencies be consolidated into the Executive Branch.[102] There is much to be said in favor of the unitary approach. If the President is directly responsible for the performance of an agency, the President may have a greater sense of responsibility for its budget, appointments, legislation, and rules than the President would for an independent agency.

Majoritarian theory clearly also favors Presidential control. Not only is this idea consistent with the democratic norm of presidential elections, but it is also the case that a single Presidential decisionmaker can prioritize budgetary and legislative preferences more effectively than unconsolidated independent agencies can.

Given these considerations, an independent regulatory agency is, in fact, the exception, not the rule. Three basic considerations typically have been urged to justify their hybrid status in the limited circumstances in which agency independence has been accorded.

First, an independent regulatory agency is depoliticized, at least to some degree, to permit resolution of specific problems on the basis of standards other than election results. The Federal Reserve Board ("Fed") is perhaps

101. WILLIAM L. CARY, POLITICS AND THE REGULATORY AGENCIES 4 (1967).

102. *See, e.g.*, Geoffrey P. Miller, *Symposium: The Independence of Independent Agencies*, 1988 DUKE L.J. 215, 220; NAT'L COMM'N ON THE PUB. SERV., URGENT BUSINESS FOR AMERICA REVITALIZING THE FEDERAL GOVERNMENT FOR THE 21ST CENTURY, x (2003), *available at* http://www.brook.edu/gs/cps/volcker/reportfinal.pdf (last visited Oct. 25, 2003) (stating that his first recommendation was: "The federal government should be reorganized into a limited number of mission-related executive departments.").

our most respected independent regulatory agency today. The "Fed" is often typified as an agency that makes economic policy decisions irrespective of the imminence of an election. A Fed, in contrast, that was part of the executive branch presumably would find it more difficult to ignore the short-term benefits of attractive interest rates or money supply even if this was less wise in the long run. Similarly, a Federal Elections Commission that was part of a political administration would be less trusted to require fair election processes than an independent agency.

The depoliticization of independent regulatory agencies has been commended particularly for agency adjudication and to a lesser degree for rulemaking. Professor Richard J. Pierce, Jr., of George Washington University, for example, has written:

> Insulation from political pressure seems most desirable in the context of adjudicatory decisionmaking by agencies. No one wants the President, or anyone else, to control the outcome of adjudicatory disputes based on the political beliefs or affiliations of the individual whose rights are at stake.
>
> Once we leave the adjudicatory context, the case for agency independence weakens. It does not disappear entirely, however. In the rulemaking context, for instance, insulating agency decisionmakers from potential presidential pressure might enhance the objectivity of the scientific analysis on which a rule is premised.[103]

Second, the independence of an agency may strengthen its adherence to legislative standards. Given the press of legislative business, only periodically will Congress consider significant new regulatory legislation. The ultimate loyalty of an independent agency in a democracy should be to the standards in its enabling legislation. Quite frequently, this legislation will long predate the current executive administration. Agency independence can be viewed as a means to protect loyalty to earlier legislation.

Third, a depoliticized independent regulatory agency may also be more effective at addressing problems requiring technical expertise.[104] This was the emphasis of Frankfurter and Landis.[105] Indeed, Frankfurter envisioned that a basic challenge of the New Deal period was to create the equivalent of a British Civil Service to better enhance the likelihood of attracting the most talented administrators to the New Deal's new independent regulatory agencies.[106]

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103. 1 RICHARD J. PIERCE, JR., ADMINISTRATIVE LAW TREATISE 65 (4th ed. 2002).
104. *See* SELIGMAN, *supra* note 1, at 58–62.
105. *See id.*
106. *Id.* at 60–61.

The experience of the SEC is not entirely consistent with these theoretical considerations. Throughout much of the Commission's history, the value of its staff's expertise has been limited by the mediocrity of presidential Commission appointments and frequently inadequate budgets. The performance of the SEC has also been influenced by other more subtle political factors. Many of the SEC's most criticized decisions, such as those concerning commission rates and the structure of the securities markets, can, in part, be traced to the Agency's failure to apply the theory of economic competition implicit in the federal antitrust laws to the securities industry, or to articulate a persuasive alternative economic theory. Other decisions of the SEC, notably those concerning accounting standard setting and corporate governance, seem to have been influenced by the breadth of the SEC's mandate. Like all other political actors, the SEC has to select programs to emphasize. In part, because of the vagueness of the relevant enabling statutes, accounting standard setting and corporate governance had been consistently relegated to the bottom of the SEC's list of priorities.

Few have seriously suggested that the SEC has been a "captive" of the industries it regulates. Quite simply, such a suggestion cannot be sustained by a reasonable reading of the Commission's history. The "capture" theory and its many variants are of relatively little use in explaining how any particular SEC decision was actually made. Such theories typically begin with the unarticulated premise that all firms and trade associations in an industry have identical aims. In fact, much of the power of an agency, such as the SEC, is derived from the divisions within the industries it regulates. Accurately perceived, the SEC did not directly "reorganize" the New York Stock Exchange in 1937-1938. The Commission enabled a reform faction within the Exchange to do so. The capture and kindred theories tend to underestimate the political force of well prepared agency studies, the idealism of agency staffs, the differences for an agency among proceeding by litigation, a rule, or legislation, and the support that can be provided to an agency by Congress or the press.

The solution of certain largely technical problems is likely to continue to be administered by independent government agencies, because Congress, the Judiciary, and the states lack sufficient time, expertise, or jurisdiction to perform these functions equally well. But history does highlight the frequently inadequate role that the White House and Congress have played in overseeing the administrative agencies. Too often appointments of SEC Commissioners have been made by the President as a form of political reward, with the competence of the appointees to perform the job not receiving sufficient consideration, and have been whisked through Senate confirmation hearings. For sustained periods, Congress has ignored serious problems in the securities or accounting profession that the SEC handled poorly. Neither

the President nor Congress for much of the recent past were effective in approving an SEC budget responsive to the problems it regulates.

To put it simply, the question of whether it is wise to have independent regulatory agencies invites consideration of a better question. If it is wise to retain independent regulatory agencies, how can these agencies be designed to operate more effectively?

IV. SELF-FUNDING

There are three fundamental techniques by which Congress and the President, in fact, exert control over independent regulatory agencies: legislation, budget, and appointments.

In a constitutional democracy, Congress should have ultimate legislative power. The independent regulatory agencies and Congress have achieved an effective harmonization of congressional constitutional control and agency expertise through agency rulemaking. Much of the detail of agency administration is achieved through elaboration of enabling legislation. To offer two prosaic illustrations, in the 2002 edition of Federal Securities Laws: 1) Selected Statutes, Rules and Forms that I coedit, the Securities Act of 1933 occupies forty-two pages, related rules and forms continue for the next 452 pages;[107] and 2) The Securities Exchange Act, the most significant federal securities law, is 188 pages long, related rules and forms stretch for 639 pages.

The balance between the independent regulatory agencies, on the one hand, and Congress and the Executive Branch, on the other, has operated less effectively with respect to budget and appointments.

The SEC, like most independent regulatory agencies, submits its budget to the White House Office of Management and Budget, which consolidates several agency budgets into a single request. Congress ultimately must both "authorize" and "appropriate" agency expenditures.[108]

The current model has fairly been criticized for underfunding the SEC, particularly during periods of surges in market activity.[109] It is an erratic model. After periods of crisis, such as that which eventuated in the Sarbanes-Oxley Act,[110] Congress and the President have been willing to make

107. *See* RICHARD W. JENNINGS & HAROLD MARSH, JR., FEDERAL SECURITIES LAW: SELECTED STATUTES, RULES AND FORMS (2002).

108. *See generally* 2 CHARLES H. KOCH, JR., ADMINISTRATIVE LAW AND PRACTICE § 7.22 (Supp. 1997).

109. *See generally* 1 LOSS & SELIGMAN, *supra* note 58, at 301–04.

110. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 101 *et seq.*, 2002 U.S.C.C.A.N. (116 Stat. 750) 750.

dramatic adjustments to the SEC's budget. In July 2002, for example, Congress "authorized" but did not then appropriate a 66% increase in the Commission's budget.[111]

To Chairman Levitt, the answer to boom-bust budgeting was agency self-funding, such as that which has long operated at the most effective independent regulatory agency, the Federal Reserve Board.[112]

Section 109 of the Sarbanes-Oxley Act establishes a form of self-funding for the newly established Public Company Accounting Oversight Board ("PCAOB"), as well as, the earlier established Financial Accounting Standards Board ("FASB").[113] Both, it bears stressing, are not independent regulatory agencies, but are private self-regulatory organizations. The PCAOB is expressly subject to SEC oversight for rulemaking and PCAOB Board members are appointed by the Commission.[114]

Under section 109(b) of the Sarbanes-Oxley Act, the PCAOB prepares an annual budget which is approved by the Commission. The income to pay for the PCAOB and the FASB is largely derived from annual accounting fees[115] which are to be equitably allocated issuers. Issuers which are separately defined in the Sarbanes-Oxley Act to mean the firms that register with the SEC under the Securities Exchange Act.[116]

The SEC already has in place an effective fee collection mechanism which in 2000 and 2001 collected over $2 billion each year.[117] In 2002, the Agency collected more than $1 billion.[118] Each of these year's collections

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111. Joel Seligman, *No One Can Serve Two Masters: Corporate and Securities Law After Enron*, 80 WASH. U. L.Q. 449, 510 (2002).

112. A Federal Reserve website usefully explains:

> How is the Federal Reserve funded?
>
> The income of the Federal Reserve System is derived primarily from the interest on U.S. government securities that it has acquired through open market operations. Other sources of income are the interest on foreign currency investments held by the System; fees received for services provided to depository institutions, such as check clearing, funds transfers, and automated clearinghouse operations; and interest on loans to depository institutions (the rate on which is the so-called discount rate).
>
> After it pays its expenses, the Federal Reserve turns the rest of its earnings over to the U.S. Treasury. About 95 percent of the Reserve Banks' net earnings have been paid into the Treasury since the Federal Reserve System began operations in 1914. (Income and expenses of the Federal Reserve Banks are included in the annual report of the Board of Governors.)

THE FEDERAL RESERVE BOARD, FREQUENTLY ASKED QUESTIONS, *at* http://www.federal reserve.gov/faq.htm#frsq4 (last visited Jan. 22, 2004). *See generally* 12 U.S.C. § 243 (2000).

113. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 109, 2002 U.S.C.C.A.N. (116 Stat. 745) 769.

114. § 101(e).

115. § 109(c)-(g).

116. § 2(a)(7).

117. 2001 SEC Ann. Rep. tbl. 16.

118. 2002 SEC Ann. Rep. tbl. 16.

exceeds even the most ambitious SEC budget proposals for 2003 and 2004. If they did not, fee levels could have been adjusted. A movement to self-funding does not appear to raise questions of feasibility.

There are also persuasive arguments that a new approach is preferable. SEC budgeting in the post World War II period has, in at least two very significant periods, been overwhelmed by market surges. During the 1950s, the Commission declined from its New Deal high of 1,678 employees in 1941 to 667 employees in 1955.[119] In the 1990s, the decline of staff effectiveness occurred coincident with booming stock market prices. In both periods this was followed by a serious increase in fraud,[120] and subsequently by large staff increases.[121]

SEC self-funding would likely reduce the extremes that have been evident in the applicable OMB-Congressional process and to some extent depoliticize budgeting.

A difficult question is not feasibility nor need, but accountability. Who would watch the guardians? At the Federal Reserve Board, a straightforward accountability system is in place. Under 12 U.S.C. § 243 the Federal Reserve Board is empowered to

> levy semiannually upon the Federal Reserve banks, in proportion to their capital stock and surplus, an assessment sufficient to pay its estimated expenses and the salaries of its members and employees for the half year succeeding the levying of such assessment, together with any deficit carried forward from the preceding half year, and such assessments may include amounts sufficient to provide for the acquisition by the Board in its own name of such site or building in the District of Columbia as in its judgment alone shall be necessary for the purpose of providing suitable and adequate quarters for the performance of its functions.[122]

Congress has two accountability mechanisms. First, under 12 U.S.C. § 248(a) there is an annual independent audit of the financial statement of the Board (as well as each Federal Reserve Bank).[123] Second, Congress retains its general oversight and legislative powers with respect to the Board.[124]

The Federal Reserve Board's self-funding has been the key to its historic high level of performance, its professionalism, and its ability to withstand political pressures. The alternative approach would require the Fed to

119. *See* 1 LOSS & SELIGMAN, *supra* note 58, at 301.

120. SELIGMAN, *supra* note 1, chs. 9–10.

121. *See* 1 LOSS & SELIGMAN, *supra* note 58, at 298. By 1962, the staff had approximately doubled to 1336 employees. *Id.* at 301.

122. 12 U.S.C. § 243 (2000).

123. *See* § 247(a).

124. *See* § 248.

seek annual budget approval from Congress. At that point, its ability to maintain independence would be reduced.

A similar approach to SEC budgeting should be enacted. The Commission currently operates under provisions such as section 6(b) of the Securities Act of 1933, designed to recover the costs of the government of the securities registration process[125] and section 31 of The Securities Exchange Act of 1934, designed to recover the costs of the supervision and regulation of securities markets and securities professionals and specified related costs.[126] Both section 6(b) and section 31 have targeted offsetting collection amounts and statutorily specified fee levels.[127]

The volatility in SEC fee collections in 2000, 2001, and 2002 strongly commends an alternative approach. As with the Fed, the SEC should be empowered to specify assessment levels on an annual or semiannual basis. Fees should solely be intended to achieve cost recovery, including, however, a contingent reserve to even out assessment volatility. The SEC should be required to file an annual audited financial statement with Congress, which could form the basis of oversight hearings. Congress, in any event, would retain its general oversight powers and ability to amend, add to, or rescind federal securities legislation.

A significant practical advantage of the Fed approach to SEC budgeting would be to avoid periodic atrophy of SEC staff during boom economies. Just as it has historically been regarded as essential to insulate the Federal Reserve Board from political pressures to protect its independent judgment on questions of monetary policy, it is also wise to insulate the SEC from staff size declines during market surges. The need for budgetary independence is similar, but not identical. History has taught us that a fundamental threat to support for an independent SEC is a successful stock market. Both Congress and the President are most likely to be supportive during periods when investor protection and fraud enforcement are emphasized. An independent budgetary process would be more effective in adjusting the size of the SEC staff to the Agency's regulatory needs during the good times, which ironically are when the SEC is more vulnerable to a lack of budgetary support.

In contrast, it is unlikely that an effective legislative change can be made to the appointments process. With occasional exceptions, the SEC in the post World War II period has usually had strong Chairs and weaker other

125. Securities Act of 1933 § 6(b), *at* http://www.law.uc.edu/CCL/33Act/Sec6.html; *see* 15 U.S.C. § 78dee (2000).

126. Securities Act of 1934 § 31, *at* http://www.law.uc.edu/CCL/34Act/Sec31.html; 15 U.S.C. § 78ee.

127. Securities Act of 1933 § 6(b), *at* http://www.law.uc.edu/CCL/33Act/Sec6.html; Securities Act of 1934 § 31, *at* http://www.law.uc.edu/CCL/34Act/Sec31.html.

Commissioners. The statutory requirements for appointment to the SEC is in section 78d(a), which provides in relevant part:

> There is hereby established a Securities and Exchange Commission . . . to be composed of five commissioners to be appointed by the President by and with the advice and consent of the Senate. Not more than three of such commissioners shall be members of the same political party, and in making appointments members of different political parties shall be appointed alternately as nearly as may be practicable. No commissioner shall engage in any other business, vocation, or employment than that of serving as commissioner, nor shall any commissioner participate, directly or indirectly, in any stock-market operations or transactions of a character subject to regulation by the Commission pursuant to this chapter. Each Commissioner shall hold office for a term of five years and until his successor is appointed and has qualified . . .[128]

Congress wisely emphasized political balance in the SEC model. But vesting the power to appoint representatives from the rival political party in the President "has made [this] provision only a pious hope" as the late Professor Loss and I elsewhere have written.[129]

During the Clinton and second Bush presidencies, a wiser appointment model has evolved by extrastatutory agreement. Senate leaders of the leading other political party have proposed the minority of the commissioners representing the rival political party. This extrastatutory approach wisely should be continued. It was striking that during the SEC Chairmanship of Harvey Pitt in 2002, Harvey Goldschmid, a second SEC Commissioner of quality equal to that of SEC Chairs, was appointed after proposal by the leaders of the leading other political party. This extrastatutory approach to SEC appointments can result in at least two highly qualified commissioners. Under article II section 2 clause 2 of the United States Constitution, however, only the President can formally exercise the appointment power to an administrative agency.[130] Neither Congress nor the SEC Chair can be empowered to make *any* appointment of a commissioner to the SEC.

Are there alternatives Congress should consider? In the Sarbanes-Oxley Act, Congress explicitly recognized that leadership quality is an issue when it provided in §101(e):

> (1) COMPOSITION. – The Board [Public Company Accounting Oversight] shall have 5 members, appointed from among prominent individuals of in-

128. Securities and Exchange Act of 1934, 15 U.S.C. § 78d(a).

129. 1 LOSS & SELIGMAN, *supra* note 58, at 292; *see generally* 1 LOSS & SELIGMAN, *supra* note 58, at 288–300.

130. *See* Buckley v. Valeo, 424 U.S. 1, 272 (1976).

> tegrity and reputation who have demonstrated a commitment to the interests of investors and the public, and an understanding of the responsibilities for and nature of the financial disclosures required of issuers under the securities laws and the obligations of accountants with respect to the preparation and issuance of audit reports with respect to such disclsoures.
>
> (2) LIMITATION. – Two members, and only 2 members, of the Board shall be or have been certified public accountants pursuant to the laws of 1 or more States, provided that, if 1 of those 2 members is the chairperson, he or she may not have been a practicing certified public accountant for at least 5 years prior to his or her appointment to the Board.[131]

Given the breadth of the SEC's jurisdiction and the risk of agency capture, it would be unwise to require any specific industry association for Commission appointment. A less far reaching approach might focus on staff experience.

There have now been over eighty commissioners appointed during the agency's nearly seventy years. SEC commissioners have come from the industry, the legal profession, Congress (both legislators and staff), White House staff, academia, and the agency itself. The most consistent appointments in terms of competence have been former SEC employees. In the New Deal period, for example, SEC Chair William O. Douglas began work at the SEC in a senior staff position. In the post World War II period, such outstanding commissioners or Chairs as Manuel Cohen, Ray Garrett, Jr., and Irv Pollack earlier served the SEC in senior staff positions.

The Securities Exchange Act could be amended to require this type of experience. For example, the amended statute might provide that the President would appoint five commissioners with the advice and consent of the Senate, including the Chair, at least one of whom was currently serving or had earlier served as General Counsel, Associate General Counsel, Director or Associate Director of an SEC Division. All commissioners should continue otherwise to be subject to the requirements of section 4(a) of the Securities Exchange Act.

I do not believe the case for such an approach can easily be made. Senior staff has also varied in talent and quality. One unfortunate consequence of such an amendment might be to politicize senior positions which usually have been made on the merits. Even with this potential concern, the competence of senior SEC staff has so significantly exceeded most SEC commissioners that this approach might wisely be considered.

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131. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 101(e), 2002 U.S.C.C.A.N. (116 Stat. 745) 751.

V. CONCLUSION

The last decade has taught much about the limitations, as well as, the strengths of the SEC. The proposal in this essay to address the SEC's budget is intended to strengthen an agency that has generally succeeded in improving investor protection. Self-funding would reduce the risk of misalignment between the SEC's staff size and statutory functions. Having recently lived through a period of trillion dollar losses to investors, in part, because of an inadequately staffed Commission, I believe the costs of a binge-purge budgeting process wisely should be alleviated.