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THE COSTS OF COMPLIANCE IN THE U.S. SECURITIES INDUSTRY

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Summary

This study is intended to contribute to development of a deeper understanding of how and to what extent various regulatory and legislative mandates have impacted compliance-related activities at U.S. securities firms. These activities have expanded and grown in importance in recent years in response to increases in compliance-related obligations. This study was undertaken to achieve three objectives: (1) developing a deeper understanding of how various regulatory and legislative mandates impact compliance-related activities at securities firms; (2) measuring compliance-related costs; and, (3) obtaining recommendations from industry firms on how to achieve the same high standard of oversight, but accomplish it more efficiently. The industry, while reaffirming its commitment to fully realizing the benefits of prudent regulation and to best practices in compliance activities, seeks to help fashion new rules and regulations whose costs do not exceed their benefits.

A broad definition of compliance costs, which encompasses the firm's overall efforts designed to achieve compliance with all applicable laws, rules and regulations, and supervision and surveillance requirements, was the foundation for this study. In its broadest sense, compliance extends well beyond the compliance department, and is an integral part of the firm's culture, affecting every employee to some degree. A survey of industry firms was conducted by the Securities Industry Association in the fall of 2005, which provided information about the overall costs of compliance, the composition of these costs and how they are borne by different types and sizes of securities firms, while revealing detailed insights into the day-to-day impact of the current regulatory environment.[1]

The principal conclusions drawn from the study include:

— The cost of compliance has risen rapidly, nearly doubling in the past three years, to reach an estimated annual total of more than $25 billion in 2005, up from $13 billion in 2002;

— This increase is significant and has had a material impact. The estimated increase in the cost of compliance between 2002 and 2005 is equivalent to almost 5% of the industry's annual net revenues;

— A substantial portion of these increased costs were avoidable, reflecting, among other things: duplication of examinations, regulations and supervisory actions; inconsistencies/ lack of harmonization in rules and regulations; ambiguity; and, delays in obtaining clear guidance; and,

— Although recently regulators have been responsive to inefficiencies evident in all stages of the regulatory process, including formulation, implementation and assessment of regulatory and supervisory changes, further improvements are needed.

[1] S. Carlson, "The Costs of Compliance in the U.S. Securities Industry: Survey Results," February 2006, (www.sia.com/surveys/pdf/CostofComplianceSurveyReport.pdf). Fifty-six SIA member firms participated in the survey. Those firms accounted for more than one-quarter of total industry net revenue and more than one-third of total industry employment in 2004.

Other findings include:

— The overwhelming bulk of total compliance costs were staffing-related. Out-of-pocket expenses and capital spending to meet compliance obligations, while less significant, increased rapidly, doubling or tripling in most cases;

— Securities firms reported receiving an average of 231 inquires per firm over the last 12 months, nearly one for each business day, with the U.S. Securities and Exchange Commission (SEC) and NASD accounting for nearly three-quarters of that total. The number of inquiries varies widely from firm to firm, ranging from an average of 98 for small firms to an average of 772 for large firms. State regulators accounted for only 7.2% of the inquiries reported by survey participants, but virtually every state was mentioned at least once and some states were mentioned as many as 13 times; and,

— Perhaps the most significant costs are those not measured by the study: the opportunity costs borne by firms and their impact on investors, who may end up paying either higher prices or who may perceive a reduction in the choices available to them.

Recommendations were obtained from industry firms and other sources on how to achieve the same high standard of oversight and investor protection, but accomplish it more efficiently. Principal among these recommendations was the need for better coordination by regulators to remove unnecessary duplication of effort and to eliminate inconsistencies in rules and regulations. Regulators should also provide clearer guidance and provide it earlier, and should develop better procedures for implementing new regulations and other compliance obligations, such as regulatory requests, "sweeps," inquiries and examinations. Finally, and not surprisingly, industry representatives would like to see a reduction of the pace and volume of new rules and regulations after sharp increases in recent years.

High on the list of needed improvements in procedures are those used to evaluate the impact of new rules and regulations on the industry, as well as their impact on different segments of the industry and on different size firms. This process should include meaningful input on the cost effectiveness of the measure under consideration from the securities industry from the very beginning, *e.g.*, when a problem is noted and a remedy contemplated. We also believe it is both desirable and possible to prepare a rigorous examination of the costs and an analysis of the benefits of each new regulatory proposal that would allow identification of the most cost-effective of the available regulatory options under consideration by applying a combination of quantitative and qualitative analysis. While federal regulators are required to perform these evaluations, their efforts have fallen short.[2] Preparing and publishing an assessment of the cost-effectiveness of proposed regulations should be an intrinsic part of the process of regulatory consultation. It plays an important role in ensuring transparency and regulatory accountability and encourages efficient regulation. Doing so could lead to elimination of a significant portion of the billions of dollars spent on compliance simply by reducing duplication of efforts, inefficiencies and waste, while still attaining regulatory goals.

This report first examines the major activities that comprise the compliance function at industry firms. This is followed by a brief discussion of three basic components of compliance costs: staff-related; out-of-pocket; and, capital. In addition, the report examines opportunity costs,

[2] For example, see U.S. Court of Appeals for the District of Columbia, June 21, 2005 (pacer.cadc.uscourts.gov/docs/common/opinions/200506/04-1300a.pdf). Also see, for example, the SEC release for Rule 38a-1 which estimated the time to achieve compliance with this rule to be only 65.5 hours, which grossly understates the industry's experience (www.sec.gov/rules/final/ia-2204.htm#P284_111035).

which, although not quantified, may be the most significant cost component. A review of key survey findings is presented next, followed by a presentation of the study's conclusions and recommendations. Finally, three appendices are included, which cover: the methodology for estimating the cost of compliance; a review of cost-benefit analysis in financial regulation; and, a discussion of statutory requirements for cost-benefit analysis.

Introduction

The regulatory environment in which the securities industry operates has undergone a dramatic transformation in the last few years reflecting both long-run trends (such as the dismantling of depression era regulations which separated the securities industry from commercial banking and insurance activities, increasing globalization, and a revolution in communication and information technology) as well as the impact of a series of unique events (including heightened security concerns following September 11, 2001, massive corporate governance failures, and the deflation of a speculative "bubble" in equity markets). Each new or revised regulation, legislative initiative or enforcement action added to the cost of compliance borne by securities firms, during a time when these firms were absorbing the costs associated with major changes in market structure and the industry's operational structure unrelated to compliance functions.

Securities firms share with regulators the common objective of maintaining a high standard of investor protection. However, increasingly industry representatives have questioned how the same high standards of investor protection and industry oversight could be achieved more efficiently. Unfortunately, although evaluations of cost effectiveness by both government agencies and private sector entities exist, each suffers from limitations. The absence of both a rigorous assessment of the costs of compliance and an evaluation of the cost effectiveness of recent regulatory and supervisory actions prompted this study.

A full year ago the SIA began developing a study that would generate more reliable estimates of the cost of compliance to the U.S. securities industry. The study pursued several objectives: (1) developing a deeper understanding of how various regulatory and legislative mandates impact compliance-related activities at securities firms; (2) measuring compliance-related costs; and, (3) obtaining recommendations from industry firms on how to achieve the same high standard of oversight, but accomplish it more efficiently.

Defining the compliance function, developing a taxonomy of compliance-related costs, and choosing the type of analysis, as well as its scale and scope, were necessary first steps before data collection could be fully undertaken. Then, in order to obtain insights into the three study objectives, a survey of SIA members was conducted in the fall of 2005. The analysis in this document draws heavily on the survey results, but also incorporates interviews and discussions with industry firms other than survey participants, existing research on the subject and other relevant sources.

The Scope of Compliance Costs

The Compliance Function

Compliance costs are the costs to the firm of carrying out its compliance functions, which in turn can be defined as each firm's general efforts designed to achieve compliance with applicable laws, rules and regulations.[3] Depending on the specific securities firm, these compliance functions may reside in several locations within the firm in addition to the compliance department. Other locations include: the risk management department; the internal audit department; the office of the comptroller, treasurer or chief financial officer; the legal department; the branch network; operations; sales; marketing; and, in many firms, the human resources department. While there are specific compliance-related functions associated with each of these departments, compliance in the broadest sense is an integral part of the firm's culture, affecting every employee to some degree.

Specific aspects of the compliance function typically include:

— Advisory roles (providing regulatory and compliance advice to business and control units on an ongoing basis);

— Policies and procedures (assisting management in the development of policies, procedures and guidelines designed to facilitate compliance with applicable laws and regulations);

— Education and training (keeping business personnel and other employees apprised of policies and procedures and regulatory events);

— Monitoring and surveillance (critical ongoing monitoring of business activities, transactions and communications, to identify potential issues, patterns of improper behavior or activities, material or systemic weaknesses and potential product-related problems);

— Business unit compliance reviews;

— Centralized compliance functions [control room function (administering information barriers within the firm), anti-money laundering (AML) program, privacy, etc.];

— Licensing, registration and employment-related functions (due diligence on new employees, advising on disciplinary issues, terminations, employee registration/licensing);

— Internal inquiries and investigations (into potential violations of supervisory controls or regulatory restrictions);

— Regulatory examinations, reporting and investigations;

— Fostering regulatory relationships and a culture of compliance/assessment of compliance programs and functions; and,

— "Chaperoning" (monitoring contact between research and investment banking personnel as required under new research analysts rules and regulations).

The structure and management of compliance functions varies substantially from firm to firm, from highly centralized to broadly distributed across departments and branch networks. The essence of compliance, however, is embedded in the concept of "supervision," where business management, not the compliance department, has ultimate responsibility to ensure that every

[3] Technical Committee of the International Organization of Securities Commissions, "Consultation Report: Compliance Function at Market Intermediaries," IOSCO, Madrid, Spain, April 2005, p. 6 (www.iosco.org/library/pubdocs/pdf/IOSCOPD198.pdf). See also public comment letters on this discussion paper including that filed by the SIA on June 30, 2005 (www.sia.com/2005_comment_letters/7359.pdf), and the recent SIA Compliance and Legal Division White Paper on the Role of Compliance, p. 5 (www.sia.com/2005_comment_letters/pdf/SIACLwhitePaper7-13-05.pdf).

element of the firm adheres to all regulatory, supervisory and legislative mandates. The compliance function supports business management in numerous ways, but, in the final analysis, responsibility for compliance rests with management.

Counting Compliance Costs

Estimating the costs associated with the various compliance functions proved far more complex than describing these functions. The direct and indirect cost of compliance were, for the sake of simplicity, grouped into four categories: staffing-related; out-of-pocket expenses; capital spending; and, opportunity costs. Not included were remediation of customer losses, fines, penalties, and settlements. Information technology (IT) costs are included within each of the three compliance cost components: staff-related; out-of-pocket; and, capital. When IT is developed internally, those costs are included in staff-related expenditures; when IT services are provided by vendors and contract staff those costs are included in out-of-pocket expenditures; and, the purchase of hardware and software systems are considered capital expenditures. Therefore, for example, the total expenditure for AML and e-mail retention compliance – compliance costs that do not diminish dramatically over time – may be captured in all of the three expenditure categories.

Staffing-Related Costs: These costs account for the overwhelming bulk (93.9%) of total compliance costs. While such costs may appear to be the most straightforward to quantify, it is far from a simple task. Certain functions (such as those in the compliance department and certain legal and financial department activities) are more easily quantified; most other staff-related costs are not. Although a firm-wide time allocation study might provide accurate insights into the proportion of time each employee devotes to compliance-related efforts, this was impractical in most cases, although some firms did just that. A more workable process, and one chosen by almost all respondents, was for management within each department to estimate the overall percent of time spent by employees reporting directly to him/her on compliance-related work and provide information on their total compensation, including fixed and variable compensation. Benefit costs and associated overhead costs were added to these time estimates and compensation information to produce an overall measure of staff-related costs.[4] The sharp rise in staff-related costs in response to the faster pace of regulatory change in recent years was accelerated by premiums paid in terms of higher compensation. This was due both to the immediate need for experienced compliance personnel who were in short supply and the elevation of the importance of the compliance function within the firm. In part, this response was to heightened concerns over the potential liabilities and costs associated with non-compliance.

Out-of-Pocket Expenses: Firms' accounting systems were generally able to identify, with relative ease, the out-of-pocket expenses associated with the direct purchase of legal, audit, accounting and other services for compliance-related activities. Firms have been spending increasing amounts of money to hire outside resources to complete a variety of compliance-related tasks, both absolutely and relative to increases in staffing and capital costs. Spending on outside resources has increased as a share of overall compliance costs, in part because of difficulties in expanding internal compliance support rapidly enough to meet sharply increased regulatory and supervisory demand. At some firms, internal resources became so overloaded that the use of

[4] The overall measure proposed to SEC staff by SIA staff and used herein employed several adjustments of survey data of compensation by securities industry occupation. These include addition of employee benefit costs and addition of fully loaded overhead (a pro-rata share of total non-interest, non-promotional expenses, etc. that are variable with respect to head count). See Appendix 1.

outside resources was often the only way to meet these new burdens by their effectiveness dates as well as to initiate non-compliance activities (such as new products and services) during this period.

The average expenditure per firm for all securities firms increased sharply over the past three years, rising 200% from an estimated $900,000 in 2002 to over $2.7 million in 2005.[5] Large firms generally reported substantially higher average absolute levels of out-of-pocket expenses. For all but small firms, whose internal resources are typically thin and easily exhausted, out-of-pocket costs represent a relatively small share of total compliance costs.

Capital Spending: With the rapid pace of regulatory change and the numerous new requirements placed on securities firms, many turned to outside vendors that provide specialized computer software geared to meeting regulatory requirements. There is anecdotal evidence to suggest that many firms purchased multiple software systems to keep pace with rapidly evolving regulatory requirements, sometimes introducing inefficiencies through operation of multiple systems, adding unnecessarily to the growth of capital costs. Additional systems were added, driving costs still higher as guidance, clarification or changes were made to the initial release of new regulatory or supervisory requirements, rendering recently purchased management information systems and reporting and disclosure systems inadequate to the task. Further costs were added when information had to be retrieved for past activities covering several (*e.g.*, five) years that were maintained on disparate legacy systems. In addition, there are hardware costs included in this measure.

Like out-of-pocket expenses, capital spending to meet compliance obligations has soared, tripling over the past three years, but representing a relatively small portion of overall compliance costs for most firms. Capital costs incurred to meet specific compliance obligations are typically heavily front-loaded, with most of the costs incurred in first-year purchases of systems to help firms comply by effectiveness dates. Systems maintenance costs are relatively smaller. In addition, one of the benefits of past capital spending is improved internal control and reporting systems, which would, one would hope, reduce future marginal costs associated with additional regulations. Unfortunately, these potential benefits are reduced by the relatively rapid obsolescence (two to three years) of hardware and software systems used by the securities industry, the rapid pace of adoption and adaptation of advances in communications and information technology by these highly competitive firms and the strong growth in the overall volume of financial transactions.

Opportunity Costs: While these represent the most challenging set of costs to identify and quantify, they are nevertheless just as real and, in some instances, more significant. Every time an employee spends additional time on compliance-related activities instead of developing business for the firm, opportunity costs are incurred. For example, branch managers who now spend 30%-40% of their time on compliance-related activities (compared with only 8%-10% five years ago) or chief executive officers who now spend up to 20%-25% on compliance-related activities (compared with only 5% five years ago) are less able to develop new business. New products and services that took weeks to introduce five years ago now take nearly a year in some instances. In addition, when different offices of the same regulator or multiple regulators request the same information, the time spent on this duplicative effort represents an opportunity cost.

[5] Based on survey data.

Opportunity costs examined included, but were not limited to: loss of time and benefits foregone (shifted management focus, disrupted provision of products and services, waiting time, etc.); limitations to entry and expansion into new products and markets; decreases in competition; effects on employment; impact on the prices and range of services offered; and, limitation of consumer choices. To the extent that these costs could be identified and quantified, they proved to be, while still significant, less than anticipated at the onset of this study. For most firms, a large portion of opportunity costs was avoided by increases in the number of hours worked and improved productivity.

Other Costs: As firms devote more and more resources to compliance-related activities, individual investors are impacted. For example, several regulatory initiatives are having the effect of limiting investors' choice of what products they can purchase and who they can select as their financial advisor. While constraints to investor choice are extremely important issues to assess, quantifying their impact, as expected, proved extremely problematic, and they were addressed qualitatively, if at all, by market participants.

Individual investors are affected in other ways as well. Increased compliance obligations have led to increased automation,[6] as well as greater reporting and disclosure of customer information, something many customers see as a cost or a reduction in benefits. For non-U.S. customers, or those with a choice of regulatory locations, these and other costs have resulted in some "migration" or "regulatory arbitrage" as business moves outside the U.S. to the detriment of U.S. markets, U.S. firms and U.S. workers.

The Incidence of Compliance Costs

SIA Survey Results - Total Compliance Costs

The cost of compliance rose rapidly over the past three years, increasing nearly 95% since 2002, with the sharpest increases occurring in 2003 and 2004. The total compliance costs incurred by the U.S. securities industry were estimated to have reached $23.2 billion in 2004, before rising 9.9% to $25.5 billion in 2005. This compares with estimated total costs of compliance of $13.1 billion in 2002.[7]

Overall, firms in the securities industry spent 10% of total or gross revenue and 13% of net revenue (gross revenue less interest expense) on compliance-related activities in 2004. This is a large percentage since the activities included comprise the broadest definition of compliance, encompassing all compliance-related activities carried out by industry firms, including staff-related, out-of-pocket, and capital expenditures. Staff-related expenditures include personnel in the traditional compliance, internal audit, risk management, and legal departments. However, they also include the increasing amount of time spent by many employees, including senior executives, on compliance-related issues, and time spent on compliance by employees in many other functions, including: Retail and Institutional businesses; IT departments; Finance and

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[6] Many firms report that costs associated with increased reporting and disclosure obligations that apply to all customer accounts have raised the "break-even" level (generally measured in terms of the dollar value of assets necessary to be profitable given average types and frequency of transactions) on those customer accounts. This has led to an increase in servicing of accounts, particularly smaller accounts, through call centers and with automated systems and a decrease in direct contact with personal financial advisors or consultants.

[7] The survey data was used to estimate the percent of net revenue that firms of different types devote to compliance-related activities. The data for securities industry revenues is drawn from the SIA DataBank and includes the income statement for all registered broker-dealers doing a public business in the U.S.

Accounting; Human Resources; Training and Education; Research; and other business areas. The study also takes into account estimated employee benefit costs and overhead in the total staff-related expense. Furthermore, this study measures out-of-pocket costs for compliance-related activities such as accounting, legal, and audit services; IT suppliers and vendors; and other compliance-related activities. The study also measures capital spending on compliance, which is largely related to the purchase of IT software and hardware.

The increased cost of compliance had a significant, material impact on securities firms. Total compliance costs already absorbed 8.3% of the U.S. securities industry's total net revenues (total revenues net of interest expense) in 2002. By 2004, this ratio had risen to 13.0%, and is estimated to be 13.1% in 2005.[8] In each of the last three years, the absolute dollar amount spent on compliance exceeded the level of industry profits (pre-tax net income).

The following table illustrates the percent of net revenue devoted to compliance-related activities, segmented by firm type for 2005.

Percent of Net Revenue Spent on Compliance: 2005

Type of Firm	Percent of Net Revenue
All Firms	13.1%
Large Firms	14.9%
Mid-sized Firms	17.5%
Small Firms	8.6%

Among the three components of compliance costs that were quantified in our survey, staff-related expense was by far the greatest, comprising more than 90% of the total for all firms. This varied considerably among different types of firms, however, as shown in the following table.

Percent of Total Compliance-Related Spending: 2005

	Staff-Related	Out-of-Pocket	Capital Costs	Total
All Firms	93.9	2.8	3.3	100.0
Large Firms	94.3	2.1	3.6	100.0
Mid-sized Firms	96.1	3.1	0.8	100.0
Small Firms	81.5	13.4	5.1	100.0

[8] Final 4Q'05 industry revenue data is not yet available.

Other Survey Findings

— Securities firms reported receiving an average of 231 inquiries per firm over the last 12 months, nearly one for each business day, with the SEC and NASD accounting for nearly three-quarters of that total.

— The costs of responding to these inquiries vary widely. For example, the costs of one annual New York Stock Exchange (NYSE) Sales Practices exam or NASD Trading and Market Making Surveillance (TMMS) exam far exceeds that of most types of inquiries.

— The NYSE accounts for a substantially larger share of inquiries when the metric is the total cost of inquiries, rather than the total number, since the NYSE regulates fewer but substantially larger firms than the NASD.

— State regulators accounted for only 7.2% of the inquiries reported by survey participants, but virtually every state was mentioned at least once – some states were mentioned as many as 13 times.

— The extent to which duplicative examinations were a concern for survey participants varied considerably, depending on the size and complexity of the firm. Overall, 44% of respondents reported that duplicative exams were a significant problem.

— Firms identified a host of legislative and regulatory initiatives that presented significant burdens, including:

- o SEC Books and Records (36 month rule);
- o Sarbanes-Oxley Act (especially Section 404, Management Assessment of Internal Controls);
- o *USA PATRIOT Act* (Anti-Money Laundering and Customer Identification requirements);
- o Supervisory Procedures and CEO Certification (NASD Rules 3010, 3012, 3013);
- o Mutual fund sales charge breakpoint self-assessment;
- o Email review and archiving; and,
- o Fee-based brokerage accounts.

— There are an increasing number of firms that operate in jurisdictions outside the United States. Many of these firms believe that they operate at a competitive disadvantage in foreign markets because they apply U.S. rules globally.

Conclusions and Recommendations

Conclusions

— Staffing costs account for the vast majority of compliance-related spending. Across the board, personnel are now devoting a higher proportion of their time to compliance-related activities than ever before. This is especially true for management personnel. In addition, securities firms have increased the number of employees fully dedicated to compliance-related activities (*e.g.*, compliance officers, auditors, accountants, legal staff, etc.) even during periods of declines in total industry employment.

— Small firms are particularly burdened because their management structure is typically thin and regulation has a high fixed cost component. This disproportionate impact has been mitigated to some extent by "safe harbors," extensions on effectiveness dates for compliance with new regulations and supervisory rules granted to small firms. Also, the incidence of regulatory inquiries is lower than that experienced by larger firms. Regulators appear to be contemplating further exemptive relief for small firms.

— While staffing, out-of-pocket and capital costs related to compliance have risen dramatically, often at double and triple digit rates, opportunity costs may represent the greatest burden, diverting scarce resources away from business development into compliance functions. However, increases in hours worked, productivity gains and the non-recurring nature of some compliance costs have helped contain, but not reduce, overall opportunity costs.

— The costs of compliance were increased and the cost-effectiveness of regulation reduced by such factors as:

  - The broad scope and rapid pace of regulatory changes;
  - The lack of inter-agency coordination and the resulting unnecessary duplication of effort; and,
  - The volume and complexity of regulation, which was not fully ameliorated by efforts to provide clarity and guidance.

— The substantial costs in terms of time, money and effort spent to implement certain regulations and to meet some inquiries was thought by most respondents to be more than necessary to achieve objectives or benefits sought.

— The higher costs to industry firms from inefficient regulation may ultimately be borne by retail and institutional investors, ironically, the very focus of protection and the intended beneficiaries of these regulations.

— Although member firms understand and accept the need for effective regulation of the industry, they are frustrated by what is perceived as a fragmented regulatory process that leads to duplication of effort and inefficiencies, resulting in:

  - Limits on business expansion and fewer choices for investors;
  - Constraints on innovation and new product development;
  - Reduced competitiveness of U.S. financial services firms and U.S. markets vis-à-vis non-U.S. competitors;
  - Higher costs and fewer choices for investors; and,
  - Higher total fixed costs, contributing to higher barriers to entry and increased industry concentration.

— Systems and procedures in place today to assess the impact of legislative and regulatory initiatives are inadequate, at best, and do not measure the true impact of regulation in any meaningful way.

Recommendations

Participating firms made a number of constructive suggestions for how to maintain high standards of oversight and investor protection in a more efficient way, including:

— Consolidation of, or at least better coordination by, regulators to remove unnecessary duplication of effort and ensure that rules and regulations are more consistent;

— Implement a better process for evaluating the impact of new rules and regulations on the industry, including meaningful input from the industry at the onset and an assessment of the cumulative effects at some fixed period after effectiveness, in order to improve cost-effectiveness;

— Give more consideration to how new rules and regulations impact firms in different segments of the industry (e.g., a full service retail firm vs. a firm that deals exclusively with government bonds);

— Provide clearer guidance, in plain English, to avoid unnecessary and wasteful guesswork by industry firms;

— Develop a better mechanism for implementing new regulations, regulatory requests, sweeps, inquiries, and examinations, focusing more on core issues rather than broad requests, so industry firms can meet their regulatory obligations and continue to conduct business effectively; and,

— Reduce the pace and volume of rules and regulations, which are now putting enormous pressure on industry firms to keep pace.

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Additional Tables

Table 1
Impact of Regulatory and Legislative Mandates on Compliance-Related Spending
All Firms
(Over the past five years)

	Major Increase (5)	(4)	Modest Increase (3)	(2)	No Increase (1)
			(percent of responses)		
Staff-related Spending	54.9	25.5	17.6	-	2.0
Out-of-Pocket Costs	51.0	37.3	5.9	5.9	-
Capital Costs	36.7	26.5	22.4	8.2	6.1
Opportunity Costs	46.9	34.7	14.3	4.1	-
Total Compliance Expenditures	58.8	33.3	5.9	2.0	-

Table 2
Extent to Which Regulatory and Legislative Initiatives Have Impacted
The Amount of Time Devoted to Compliance Since 2002

	Major Increase (5)	(4)	Modest Increase (3)	(2)	No Increase (1)
			(percent of responses)		
All Firms					
Staff	58.5	34.0	5.7	1.9	-
Management	65.5	30.9	3.6	-	-
Large Firms					
Staff	50.0	50.0	-	-	-
Management	75.0	25.0	-	-	-
Mid-sized Firms					
Staff	54.5	27.3	18.2	-	-
Management	36.4	54.5	9.1	-	-
Small Firms					
Staff	61.8	32.4	2.9	2.9	-
Management	72.2	25.0	2.8	-	-

Table 3

Compliance-Related Out-of-Pocket Expenditures
Average Expenditures and Percent Increase Since 2002

Type of Expense	Average* Expenditure Per Firm	Average** Percent Increase
All Firms		
Accounting Services	$441,081	135.7
Legal Services	$1,313,895	140.2
Audit Services	$362,781	88.2
IT Suppliers & Vendors	$771,918	144.6
Other Services	$996,355	473.7
Large Firms		
Accounting Services	$2,867,500[1]	147.2[1]
Legal Services	$5,350,077	91.1
Audit Services	$1,670,600	104.0
IT Suppliers & Vendors	$3,027,289	160.0
Other Services	$5,526,000[1]	601.7[1]
Mid-sized Firms		
Accounting Services	$281,520	93.9
Legal Services	$741,592	31.6
Audit Services	$215,294	81.1
IT Suppliers & Vendors	$503,851	66.1
Other Services	$372,133	42.2
Small Firms		
Accounting Services	$74,808	129.2
Legal Services	$639,000	283.8
Audit Services	$73,242	36.8
IT Suppliers & Vendors	$135,014	166.3
Other Services	$373,726	181.1

** Simple averages*
*** Weighted averages*
[1]Small sample

Table 4

Compliance-Related Capital Expenditures
Average 2005 Expenditure and Percent Increase Since 2002

Type of Expense	Average* Expenditure Per Firm	Average** Percent Increase
All Firms	$3,959,543	366.1
Large Firms	$21,316,151	331.8
Mid-sized Firms	$511,500	144.7
Small Firms	$481,324	347.1

** Simple averages*
*** Weighted averages*

Table 5

Reported Inquiries by Type and Regulator - All Firms
(percent distribution)

	Total	Regulatory	Supervisory	Investigative	Other
SEC	41.6	10.1	0.2	11.9	19.5
NASD	31.2	14.0	0.4	8.5	8.4
NYSE	12.3	8.6	0.0	2.1	1.6
AMEX	0.8	0.4	0.0	0.3	0.1
CBOE	1.9	1.0	0.0	0.6	0.4
State Regulators	7.2	4.4	0.1	2.2	0.4
Other	4.8	2.3	0.1	2.0	0.4
Total	100.0	40.7	0.8	27.5	30.9

Note: Totals may not add due to independent rounding.

Table 6

Average Number of Inquiries per Firm – All Firms

	Total	Regulatory	Supervisory	Investigative	Other
SEC	94.3	23.2	0.4	27.5	45.0
NASD	73.5	32.9	0.9	19.9	19.8
NYSE	29.0	20.2	0.1	4.9	3.8
AMEX	2.0	1.0	-	0.7	0.3
CBOE	4.6	2.3	-	1.4	0.9
State Regulators	16.8	10.4	0.2	5.3	0.9
Other	11.4	5.4	0.3	4.6	1.0
Total	230.7	94.0	1.9	63.5	71.2

Note: Totals may not add due to independent rounding.

Table 7

Average Number of Inquiries per Firm

	All Firms	Large Firms	Mid-sized Firms	Small Firms
SEC	94.3	256.9	121.6	49.9
NASD	73.5	230.0	78.4	33.9
NYSE	29.0	136.4	28.0	3.4
AMEX	2.0	7.8	0.5	1.1
CBOE	4.6	24.6	1.7	0.7
State Regulators	16.8	65.5	12.8	6.6
Other	11.4	50.6	5.8	3.7
Total	230.7	771.8	247.6	97.9

Note: Totals may not add due to independent rounding.

Table 8

Extent to Which Regulators Conduct Duplicative Examinations

	Considerable Extent (5)	(4)	Modest Extent (3)	(2)	Minimal Extent (1)
			(percent of responses)		
All Firms	17.3	26.9	30.8	3.8	21.2
Large Firms	12.5	50.0	37.5	-	-
Mid-sized Firms	18.2	36.4	36.4	-	9.1
Small Firms	18.2	18.2	27.3	6.1	30.3

Glossary

Administrative Costs – All agency personnel and non-personnel costs associated with implementing a regulation, including technical, legal and management oversight and enforcement, involving all agencies at the federal, state and local levels, where applicable, and including indirect costs, estimated separately from direct costs.

Benefit Analysis – The research and analysis used to estimate the added societal gains expected from a regulation. Benefit analysis generally requires the melding of scientific, technical, and economic research and analysis to develop quantifiable as well as non-quantifiable measures and descriptions of the benefits of a regulation.

Books and Records Requirements (36 month rule) – A requirement under Rule 17a-3 where broker-dealers must send out a letter requesting updates to information received when they took an order from a customer 36 months prior. It is only applicable to those accounts where the broker-dealer did a suitability determination; that is, made a recommendation on what securities that person should buy and/or sell.

Capital Costs – Expenditure on goods such as software, hardware, equipment, buildings, and other physical assets to meet regulatory compliance requirements.

Compliance Costs – All costs associated with a regulated entity following all the proposed elements of regulation, supervision and legislation.

Cost Analysis – The research and analysis used to estimate the coverage and compliance costs of a regulation for regulated entities.

Cost Benefit Analysis (CBA) – A conceptual framework that is designed to compare a policy's or regulation's incremental and total costs to its incremental and total benefits. Typically, CBA attempts to quantify monetary values on the costs and benefits to arrive at a net-benefit figure, which could be positive or negative.

Cost Effectiveness Analysis (CEA) – An approach for comparing alternative programs or regulations when the benefits are difficult if not impossible to translate into dollar terms. The benefits are referred to as "effectiveness measures" and the costs of attaining that measure are monetized. CEA generally employs ratio analysis to rank and compare alternative programs or regulations.

Direct Costs – Expenditures for a good or service to a supplier/vendor or employee.

Email Review and Archiving – SEC Rules 17a-3 and 17a-4, particularly 17a-4(b)(4) (for business communications) and 17a-4(f) (archiving requirements).

Fee-based Brokerage Accounts – In 2005 the SEC adopted a rule (Certain Broker-Dealers Deemed Not To Be Investment Advisors [Release Nos. 34-51523; IA-2376; File No. S7-25-99]) under which a broker-dealer providing advice that is solely incidental to its brokerage services is excepted from the Advisors Act if it charges an asset-based or fixed-fee (rather than a commission, mark-up, or mark-down) for its services, provided it makes certain disclosures about the nature of its services (www.sec.gov/rules/final/34-51523.pdf).

Incremental Benefits and Incremental Costs – The added gains or improvements (benefits) and extra or additional costs imposed as a result of a change from the current state, occurring either from a change in regulatory policy or practice or over a period of time. The term incremental is often used interchangeably with marginal.

Indirect Benefits and Indirect Costs – Indirect Benefits are secondary gains or improvements occurring as a result of changes induced by the regulation. Generally, positive effects other than those intended or assumed to occur directly as a result of regulation. Similarly, indirect costs are costs other than those incurred as a result of regulation. Generally, it includes costs other than those incurred as a result of compliance efforts.

Monetized Value or Monetary Valuation Estimates – The dollar values of estimated benefits or costs when their value is not directly observable but still quantifiable (either through the price paid for a good or service or a simulated market price created to determine the price that would prevail in a market transaction).

Mutual Fund Sales Charge Breakpoints – Mutual funds that have front-end sales charges may offer discounts for larger investments; the amounts at which these discounts become available are called "breakpoints." The NASD required certain member firms that sell front-end load mutual funds to conduct self-assessments of breakpoint compliance.

Net Benefit/Cost Calculations – The difference between the quantified costs and benefits of a regulation.

Non-Quantifiable Benefits or Costs – Gains or improvements (benefits) or costs from a regulation for which monetary valuation estimates cannot be made, because of the nature of the benefits or costs or because of the lack of an adequate base of information. Generally qualitative descriptions are provided instead.

Ongoing or Operational Costs – Labor, materials, energy, service or other annual operating expenses that are associated, either directly or indirectly, with meeting regulatory compliance requirements. Costs other than those one-time or start-up costs incurred to come into initial compliance with regulations.

Peer Review – A process whereby research and analysis is subject to outside review and comment by qualified individuals, a panel or an agency to ensure accountability to standards.

Regulatory Impact Statements (RIS) – An analysis wherein an agency or other interested party explains the developmental process of a rule, as well as the impact of the rule, generally employing CBA. Among the topics generally addressed in an RIS are the following: the statutory authority for the rule or regulation; the necessity for and the benefits of the regulation; the costs of the regulation to the regulated entity and to government entities (administrative, including enforcement, costs); legal requirements duplicated by the regulation, alternatives to the regulation (including their relative costs and benefits); and whether the regulation meets or exceeds federal standards, and if so, why. Sometimes RIS are called Regulatory Impact Assessments, such as those undertaken by the U.S. Environmental Protection Agency.

Sarbanes-Oxley Act or SOX – *The Public Company Accounting and Reform and Investor Protection Act of 2002*, P.L. 170-204 (107th Congress, 1st Session). Section 404 of SOX sets out the requirement that company annual reports include an internal control report which (1) describes management's responsibilities for establishing and maintaining an adequate internal control structure and procedures for financial reporting and (2) contains an assessment of the effectiveness of the internal control structure and procedures. Section 404 also mandates internal control evaluation and reporting by the registered public accounting firm that prepares the audit report, including an attestation to and report on the assessment made by management.

Start-Up Costs – Initial and non-recurring costs of regulated entities associated with responding to a revised or new regulation.

Supervisory Procedures and CEO Certification – NASD Rule 3010 requires the establishment and maintenance of systems to supervise the activities of each registered representative and associated person in order to achieve compliance with the securities laws, regulations, and NASD rules. NASD Rule 3012 requires the designation of principals who will establish, maintain and enforce supervisory control policies and procedures that test and verify that the member's supervisory procedures are reasonably designed to comply with applicable securities laws and NASD rules. NASD Rule 3013 requires the designation of a chief compliance officer and that the chief executive officer (CEO) or equivalent officer certify annually that processes are in place to establish, maintain, review, test, and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable NASD rules and securities laws and regulations.

Transaction Costs – Real resources, including time, that go into complying with a specific regulation. Lost productivity and other costs incurred awaiting approval or certification or costs associated with delays in attaining certification of compliance with regulations are included as transaction costs.

USA PATRIOT Act – *Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001* directed the issuance of regulations requiring financial institutions to implement reasonable procedures for (1) verifying the identity of any person seeking to open an account, to the extent reasonable and practicable; (2) maintaining records of the information used to verify the person's identity; and, (3) determining whether the person appears on any list of known or suspected terrorists or terrorist organizations.

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Appendix 1: Methodology for Estimating the Costs of Compliance

This study was prompted by the frequent expressions of frustration by industry firms with the current regulatory process and, particularly, with the pace and scope of new regulatory and legislative initiatives over the past three years. Industry firms expressed concern about the current regulatory system being out of alignment and inefficient with:

— multiple regulators rapidly initiating new rules and regulations, that were often neither fully coordinated/harmonized nor clear (and raising concerns over regulatory "competition");

— firms being examined by multiple organizations, whose efforts were often duplicative;

— increasing human and financial resources to keep pace with new compliance requirements were obtained at a premium, increasingly from outside suppliers; and,

— investors paying a high price through increased costs, fewer choices, and more paperwork.

At the same time, many changes are taking place within the regulatory environment. Therefore, this is the perfect time to consider new alternatives that can maintain the high level of oversight in place today, but accomplishes that most efficiently. This report serves as a platform for discussion.

The concept of the study and the details of the survey questionnaire were developed in collaboration with many groups at SIA, including the following:

—Independent Firms Committee
—Federal Regulation Committee
—Self-Regulation Committee
—Small Firms Committee
—Regional Firms Committee
—Compliance and Legal Division

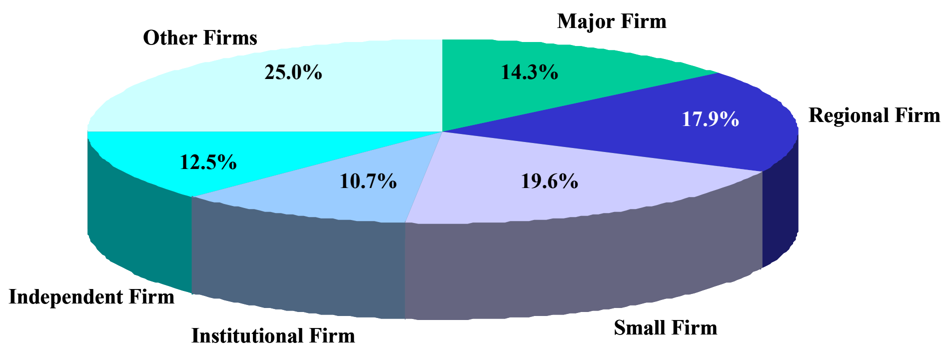
In addition, many individual discussions were held with senior executives at SIA member firms. Some of those discussions were held at firms' headquarters and others were conducted by phone.

In October 2005, the survey was finalized and distributed to SIA member firms. The questionnaire solicited both quantitative information (*e.g.*, compliance-related costs and number of regulatory inquiries) and qualitative information (*e.g.*, the degree to which duplicative examinations are conducted) in an effort to get a complete picture. Gathering reliable "hard" data on compliance spending presented some significant challenges. After numerous discussions with senior compliance executives, Chief Financial Officers, and senior accounting management, an effective methodology was developed. Essentially, the decision was made to obtain compliance cost data in three categories: staffing-related; out-of-pocket expenses; and, capital spending. Officials familiar with accounting practices at industry firms felt the latter two categories would be reasonably straightforward to obtain from accounting records. However, the staff-related element presented a more significant challenge. To get reliable staffing costs, firms were asked to look at various functions within their firm and provide data on the number of employees in each function, the average amount of time those employees spend on compliance-related activities, and the average total compensation per employee. It was felt that this approach would provide the most accurate and complete estimate of staffing costs.[9]

By December 2005, fifty-five firms had completed and returned questionnaires. This sample of firms was compared to the distribution of firms in the industry as a whole to ensure that the sample represented a good cross-section of the industry both in terms of firm type and size.

Figure 1

Cost of Compliance Survey Participants



Industry data was drawn from the SIA DataBank. All U.S. registered broker-dealers are required to file Financial and Operational Combined Uniform Single (FOCUS) Reports with the SEC and their self-regulatory organizations (SROs) for regulatory purposes. This data is aggregated by the two principal SROs, the regulatory arms of the NYSE and the NASD, which are combined, maintained and published by SIA in two complementary databases: the Securities Industry DataBank (NYSE) and Expanded Securities Industry DataBank (NASD).[10] Combined financial results are referred to herein as the "SIA DataBank." Based on FOCUS Report data, which covers only the domestic broker-dealer operations of U.S. securities firms, at end-September 2005, there were 5,184 broker-dealers doing a public business in the U.S.: 219 NYSE-reporting firms and 4,965 NASD-reporting firms other than those reporting to the NYSE. 170 firms reporting to the NYSE also report to the NASD.

For the purposes of this report, firms were organized into three firm-size categories: Large Firms, Mid-sized Firms, and Small Firms.

Firm Category	Net Revenue	Employees
Large Firms	Over $500,000,000	More than 1,000 employees
Mid-sized Firms	$50,000,00 to $500,000,000	100 to 1,000 employees
Small Firms	Less than $50,000,000	Fewer than 100 employees

Note: Net Revenue = Gross Revenue less Interest Expense

[9] www.sia.com/surveys/pdf/CostofComplianceSurveyReport.pdf.

[10] For further details, see www.sia.com/research/html/databank.html and www.sia.com/research/html/expanded_databank.html.

The industry-wide distribution of these three firm-size categories by net revenue, number of firms and number of employees is presented immediately below. Definitions of these firm-size categories are provided on the following page.

Net Revenue by Firm Size, 2004		
	Net Revenue ($ Millions)	Percent of Total
All NASD & NYSE Firms	$178,291	100.0%
Large Firms	91,819	51.5
Mid-sized Firms	23,857	13.4
Small Firms	62,615	35.1
Source: SIA DataBank		

Number of Firms by Firm Size, 2004		
	Number of Firms	Percent of Total
All NASD & NYSE Firms	5,219	100.0%
Large Firms	45	0.9
Mid-sized Firms	164	3.1
Small Firms	5,010	96.0
Source: SIA DataBank		

Number of Employees by Firm Size, 2004		
	Number of Employees	Percent of Total
All NASD & NYSE Firms	396,237	100.0%
Large Firms	263,243	66.4
Mid-sized Firms	70,407	17.8
Small Firms	62,587	15.8
Source: SIA DataBank (Note: These numbers are understated because employment figures are not reported by thousands of small firms (4,655 in 2004) that file a short-form Part IIA FOCUS Report.) The U.S. Department of Labor, Bureau of Labor Statistics, *Employment, Hours, and Earnings from the Current Employment Statistics Survey (National)*, reports that for the "securities, commodity contracts, investments" industry, NAICS Code 523, annual average employment was 766,100 in 2004 and 783,300 in 2005.		

The received survey data was aggregated and analyzed and estimates made for industry-wide spending on compliance. Those estimates were developed using the following approach:

(1) Using the survey data, metrics were developed for the percent of net revenue spent on compliance-related activities by firm. This involved combining staff-related, out-of-pocket and capital costs for each firm and dividing by net revenue.

(2) The staffing-related compensation data was expanded to include benefits and overhead in total staff-related costs. Information on benefits costs were drawn from a number of sources, principally the SIA survey, *Report on Employee Benefits Practices, 2004*. Overhead expenses are included because they are a necessary expense for employees to perform their various functions. As such they become an integral part of total staff-related expense. For this estimate, industry-wide data from SIA's DataBank was used to develop a ratio that expanded total compensation to include overhead. Expenses included as overhead were: Communications, Occupancy & Equipment, EDP, Regulatory Fees and Other Expenses. The following expense items were excluded: Floor Costs; Promotional Costs; Interest Expense; Error Account & Bad Debt Losses; and, Non-Recurring Charges. The resulting factor to expand total compensation to include overhead was 1.68 in 2004 (Total Compensation & Overhead Expenses divided by Total Compensation).

(3) The percent of net revenue spent on compliance-related activities from the survey was aggregated by firm size and then applied to industry-wide net revenue FOCUS Report data from SIA's DataBank for these same size groupings. We then summed the size group's compliance costs to estimate industry-wide compliance costs, which then enabled us to calculate the percent of net revenue spent on compliance-related activities on an industry-wide basis.

In addition, qualitative information on "Opportunity Costs" was obtained from the survey participants as well as from those interviewed whose firms did not respond to the survey.

Definitions of Firm Categories by Firm Size

Large Firms	Major Firms: These NYSE-member firms include the largest U.S. broker-dealer subsidiaries of global financial holding companies, all self-clearing. They usually have thousands of employees, an international presence and generate many hundreds of millions and even billions in revenue from investment banking, capital markets activities, and/or from diverse securities product lines both retail and institutional. They account for the vast majority of revenues and employees in the U.S. Large Regional Firms (Non-New York): The largest full service NYSE broker-dealers, usually self-clearing with regional branch network systems (i.e. Midwest, Northeast) providing a wide array of financial services and products to both retail and institutional clients (similar to Majors but on a much smaller regional scale). Large New York City-Area Regional Firms: New York City headquartered NYSE broker-dealers, including some firms who have set up headquarters just across the Hudson River in New Jersey. These firms, mostly self-clearing, conduct a broad array of financial services including brokerage, investment banking, trading, money management, etc. for both retail and institutional clients. This group includes most U.S. broker-dealer subsidiaries of foreign banks and financial institutions.
Mid-sized Firms	Medium–sized Regional firms: These NYSE-member firms are similar to Large Regionals, but have a smaller revenue base. Discounters: NYSE-member firms that hold themselves out as, and are primarily engaged in, the discount brokerage business. Commissions, mainly retail, are their primary revenue source. Includes both self-clearing and introducing discounters and their clearing subsidiaries. Does not include multi-business broker-dealers that offer discount commissions as just one of many business lines. Clearing Firms: NYSE-member firms principally engaged in correspondent clearing. Other Medium-sized Firms: All other NYSE member broker-dealers which are self-clearing but do not meet the specifications of any of the preceding firm categories. Medium-sized NASD-reporting members (other than the NYSE-reporting): This group includes firms primarily engaged as market makers, dealers and principal trading, clearing firms, and all other exchange member firms.
Small Firms	Small Regional Firms: These NYSE-member firms are similar to Large Regionals, but have a smaller revenue base. Small New York City-Area Regional Firms: These NYSE-member firms are similar to Large NYC-Area Regional Firms, but have a smaller revenue base. Commission-Introducing Firms: NYSE-member broker-dealers which only “introduce” commission business, but do not carry or clear their own customer accounts. This group files a short-form Part IIA FOCUS Report that is not totally comparable to the long-form Part II FOCUS Report filed by all other NYSE-members. Sole-NASD: This group includes sole NASD clearing firms, bank broker-dealers, fully-disclosed firms, broker’s brokers, commodities introducing firms, insurance product firms, mutual fund firms, M&A firms, and all other firms.

Appendix 2: Cost-Benefit Analysis in Financial Regulation

Applying economic analysis to financial regulation, "in particular, cost-benefit analysis (CBA) is a practical and rigorous means of identifying, targeting and checking the impacts of regulatory measures on the underlying causes of the ills with which regulators need to deal, those causes being the market failures that in turn may justify regulatory intervention."[11] It also allows similar assessment of the impacts of regulatory measures on those who are subject to those regulations, in particular, the costs financial firms encounter in complying with them.

CBA is a long-established discipline of applied economics and it has been used for decades by government departments and private sector entities, both in the U.S. and abroad, as an appraisal tool for public expenditure and policy actions. However, while there is a considerable body of CBA in many areas, the development of cost-benefit techniques for and their application to financial regulation have been limited. Further, although federal agencies are required to rigorously evaluate the costs and benefits of the regulations they issue, some of these efforts have fallen short.[12]

While a full quantitative evaluation of costs and benefits is difficult to achieve and often considered unnecessary, it is both desirable and usually possible to identify the most cost-effective of the available regulatory options by using a combination of qualitative and quantitative information. Preparing and publishing a CBA is an intrinsic part of the process of regulatory consultation and plays an important role in ensuring transparency and regulatory accountability. Providing an estimate of the costs and an analysis of the benefits (even if only in qualitative terms) of each proposed regulatory action for review and comment whenever their impact is likely to be a more than minimal increase in the costs of those affected is essential for efficient regulation.

Both the theoretical criticisms of CBA and how these criticisms are addressed in practice are outside the scope of this paper. Addressing the practical problems that arise in the identification and analysis of relevant costs of financial regulation is our focus here. Their absence from any governmental cash flows makes discovery of the relevant costs and benefits an inherently difficult task. The total direct costs of financial regulation consist of resources employed by government agencies and by the private sector, but the focus of this report is only on the latter. Since this report develops estimates only of the impact on those who are regulated, it understates the full cost of these regulations. Regulatory and supervisory agency spending – the cost component this report excludes – amounts to only about a small percentage of the non-budgeted compliance costs on which this report focuses. Nonetheless, spending by the SEC and the SROs has risen rapidly in recent years. For example, the SEC's budget reached $913 million in 2005, a non-trivial amount, and has increased 77 percent since 2002, outpacing growth of government spending in virtually every other area. Funding the SROs' budgets, which are borne by their member firms, and other regulatory costs are not captured in this report, most noticeably indirect burdens and general equilibrium effects, such as transfer effects.

[11] Isaac Alfon and Peter Andrews, "Cost-Benefit Analysis in Financial Regulation: How To Do It and How It Adds Value," FSA Occasional Paper Series, No.3, The Financial Services Authority, London, September 1999, p. 5. See also, D.T. Llewellyn, "The Economic Rationale for Financial Regulation," FSA Occasional Paper Series, No. 1, The Financial Services Authority, London, April 1999.

[12] See Appendix 3: Statutory Requirements for Cost-Benefit Analysis contained herein.

The paucity of readily available information on compliance costs can be addressed in a number of ways, including the use of a survey questionnaire, reference to existing research and discussions with a sample of firms. Each of these methods was employed in this study. The results of the survey are presented herein. These results were used, along with additional observations drawn from other survey data and discussions. Discussions included Congressional hearings, a SEC Roundtable,[13] various private sector/SIA events (panel discussions at conferences, roundtables, division/committee meetings, etc.), and direct interviews with market participants. However, defining the compliance function, developing a taxonomy of compliance-related costs, choosing the type of analysis, as well as its scale and scope, were all necessary prerequisites to the collection of data.

[13] See for example, the transcript of discussions or web cast archives of the SEC Roundtable on the Implementation of Internal Control Reporting Provisions held at the SEC on April 13, 2005 in Washington, DC (www.sec.gov/spotlight/soxcomp.htm). A summary of General Comments and Detailed Observations and Recommendations prepared by SEC Staff can be found at Exhibit The Sarbanes-Oxley Act of 2002: a Culmination of Corporate Reform Initiatives by the Bush Administration, the SEC and Congress Prepared for Commissioner Cynthia A. Glassman in connection with the SIEPR Economic Summit Assessment of the Sarbanes-Oxley Act Critical Issue Session, February 11, 2005, as modified: 02/22/2005 (www.sec.gov/news/speech/spch021105cag-exa.pdf).

Appendix 3: Statutory Requirements for Cost-Benefit Analysis

Most analysts agree that the first legislative mandate to use CBA came from the Flood Control Act of 1936.[14] In the decades that followed the use of CBA slowly increased in connection with multiple uses of water resources and transportation analysis. Following a major expansion of health, safety and environmental regulation in the late 1960s and early 1970s, companion programs to evaluate the regulatory system were produced and the use of CBA expanded more rapidly. This expansion occurred largely without further legislative mandate through a series of Executive Orders.[15] Generally the requirement is limited to "major" rules, defined as those with an expected economic impact exceeding $100 million or otherwise deemed important by the Office of Management and Budget (OMB)[16], and various OMB documents provided guidance on procedures for applying cost-benefit analysis.[17]

Congress has long recognized the limitations of CBA.[18] In the late 1990s Congress sought[19] a requirement not only that a cost-benefit analysis of major rules be conducted, but that the analysis consider not only the rule versus no rule (cost-benefit analysis), but also alternative ways to implement the rule than might be more cost effective (cost-effectiveness analysis). The Act did not require that the most cost effective approach be taken, but did require that it be assessed and if not taken that the agency promulgating the order would need to explain why not. The OMB was charged with overseeing this process of "peer review." Although the Act was not approved, many of its proposed requirements were subsequently adopted and cost-effectiveness analysis gained broader acceptance.

[14] Section I of the Act states that "the Federal Government should improve or participate in the improvement of navigable waters or their tributaries including watersheds thereof, for flood-control purposes *if the benefits to whomsoever they may accrue are in excess of the estimated costs,* and if the lives and social security of people are otherwise adversely affected." See, 74th CONGRESS. SESS. II. CHS. 651, 688. JUNE 20, 22, 1936. www.ccrh.org/comm/cottage/primary/1936.htm

[15] Office of Management and Budget, Draft Report to Congress on the Costs and Benefits of Federal Regulations, "Development of the U.S. Regulatory Analysis Program," pp. 9-12, Washington, D.C. 1997. These Executive Orders (EOs) include EO 11821, issued in 1974, which required government agencies to prepare inflation impact statements before they issued costly new regulations. The economists at President Ford's Council on Wage and Price Stability "quickly concluded that a regulation would not be truly inflationary unless its cost to society exceeded the benefits it produced. Thus the economists turned the inflation impact statement into a benefit-costs analysis. This requirement, that agencies do an analysis of the benefits and costs of their 'major' proposed regulations… was adopted in modified form by each of the four next Presidents."

[16] See for example Executive Order 12866, "Regulatory Planning and Review," issued September 30, 1993.

[17] These administrative procedures developed by OMB and other agencies grew out of efforts to adhere to the principles of EO 12866, as well as three statutes that require agencies to follow certain procedures and/or various economic impacts before taking regulatory action: the *Unfunded Mandates Reform Act of 1995*, the *Paperwork Reduction Act of 1995* and the *Small Business Regulatory Enforcement Fairness Act of 1996*.

[18] Major health and safety statues, such as the *Clean Air Act* and the *Occupational Safety and Health Act*, prohibited CBA's use to determine a standard. Instead, most environmental regulation is "technology based," requiring the best available methods for controlling pollution. Agencies have often sought to base decisions on "net benefits" determinations (monetized benefits minus costs). Current guidelines say that agencies may use CEA (the ratio of costs to units of benefits) in place of a "net benefits" analysis if they have difficulty monetizing benefits.

[19] See the *Regulatory Improvement Act of 1997*, later resubmitted as the *Regulatory Improvement Act of 1998*. The Act, among other things, sought to amend Chapter 6 of Title 5, U.S. Code, to require federal agencies to complete specific studies, including cost-benefit analyses and risk assessments, as part of the regulatory analysis performed before certain major rules are issued. A summary of the 1998 version of the Act can be found at www.senate.gov/~gov_affairs/regsum.htm.

The SEC is under a number of statutory obligations to consider the economic impact of its regulatory proposals. For example:

— In 1996 the *National Securities Markets Improvement Act* (NSMIA) Pub. L. No. 104-290, 110 Stat. 34, amended Section 2 of the *Securities Act of 1933* and Section 3 of the *Securities Exchange Act of 1934* (*Exchange Act*), among others, to require the SEC in its rulemaking to consider "in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."

— The *Small Business Regulatory Fairness Act of 1996*, Pub. L. No. 104-121, 110 Stat. 857 (*Regulatory Fairness Act*) requires, among other things, that a federal regulatory agency, in promulgating a final rule, must make:

> "A description of and an estimate of the number of small entities to which the rule will apply or an explanation of why no such estimate is available,"
>
> "a description of the projected reporting, recordkeeping and other compliance requirements of the rule, including an estimate of the classes of small entities which will be subject to the requirement and the type of professional skills necessary for preparation of the report or record," and
>
> "a description of the steps the agency has taken to minimize the significant economic impact on small entities . . . ." [See Pub. Law No. 104-121, Title II, Subtitle D, Sec. 241 (b), codified as 5 U.S.C. Sec. 604 (a).]

In addition, rules that are found to be likely to result in an annual effect on the economy of $100 million or more are subject to Congressional review and potential override. [See Pub. Law No. 104-121, Title II, Subtitle E, Sec. 251, codified at 5 U.S.C. Sec. 804(2) (A).]

On June 21, 2005, the U.S. Court of Appeals for the District of Columbia ruled that the SEC had violated the *Administrative Procedure Act* by not adequately considering the compliance costs that mutual funds would incur in complying with an SEC rule approved in June 2004. Chief Judge Douglas Ginsburg, giving the court's opinion, said the SEC had an "obligation to do what it can to apprise itself — and hence the public and the Congress — of the economic consequences of a proposed regulation before it decides whether to adopt the measure." (See pacer.cadc.uscourts.gov/docs/common/opinions/200506/04-1300a.pdf.)

The SEC's July 7, 2005 response to the remand by the U.S. Court of Appeals on the decision on investment company governance employed estimates based on salary surveys conducted by the SIA, "a source on which we commonly rely in our rulemakings" (www.sec.gov/rules/final/ic-26985fr.pdf). SIA expressed concerns over the use to which the SEC applied SIA data and provided the SEC staff with additional information to enable more accurate estimates.

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