

**FINANCIAL SERVICES AND GENERAL GOVERNMENT
APPROPRIATIONS FOR FISCAL YEAR 2012**

HEARINGS

BEFORE A

SUBCOMMITTEE OF THE
COMMITTEE ON APPROPRIATIONS
UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

ON

H.R. 2434/S. 1573

AN ACT MAKING APPROPRIATIONS FOR FINANCIAL SERVICES AND
GENERAL GOVERNMENT FOR THE FISCAL YEAR ENDING SEPTEMBER
30, 2012, AND FOR OTHER PURPOSES

Commodity Futures Trading Commission
Department of the Treasury
Securities and Exchange Commission
Small Business Administration

Printed for the use of the Committee on Appropriations



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FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2012

TUESDAY, APRIL 5, 2011

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 10:10 a.m. in room SD-138, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.

Present: Senators Durbin, Lautenberg, Moran, and Kirk.

DEPARTMENT OF THE TREASURY

OFFICE OF THE SECRETARY

STATEMENT OF HON. TIMOTHY F. GEITHNER, SECRETARY

OPENING STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. Good morning. I'm pleased to convene this hearing of the Appropriations Subcommittee on Financial Services and General Government, the first in a series of hearings we're going to have this spring as we embark on the 2012 appropriations bills.

I want to welcome my Ranking Member, Senator Jerry Moran of Kansas. Welcome in your new position here.

Senator MORAN. Thank you.

Senator DURBIN. I am looking forward to working with you.

And, of course, my colleague from Illinois, Senator Mark Kirk—we've both worked together on many things.

And let me start with an apology to the Secretary and to my colleagues, but it's all the President's fault. He decided, at the last minute, to call in the leaders, including Senator Reid, and I had the responsibility of opening the Senate. So, I apologize to all of those who are in attendance.

Today, we're going to examine the fiscal year 2012 funding request for the Department of the Treasury. While the Treasury programs funded in our appropriations bill include the Internal Revenue Service (IRS) and the Community Development Financial Institutions Fund (CDFI), we're planning to look at those two agencies separately. We'll save questions on those for focused hearings.

The Treasury programs we're going to talk about today are programs which deliver a generous return on investment to taxpayers. I'd like to illustrate a few examples.

Before any coalition planes were in the sky over Libya, the Department of the Treasury's Office of Foreign Assets Control had frozen \$32 billion in Libyan assets. That's \$32 billion that Muammar Gaddafi can't use to pay mercenaries, gas up his tanks, or purchase weapons to kill his own people.

The Treasury's Financial Crimes Enforcement Network (FinCEN), tracks the financial paper trail when a criminal tries to steal your identity, cash out the equity in your home, or skim your credit card. And again, when that criminal tries to wire your money abroad, blow your money on blackjack, or even flee the country with a pocketful of diamonds, it's the Treasury's FinCEN that follows the money to make sure crime doesn't pay for terrorists, financiers, organized crime, narcotics traffickers, Ponzi scheme operators, and loan modification scammers.

The Treasury's Financial Management Service ensures that Social Security payments make their way to seniors, that benefit payments make their way to our disabled veterans, and, as many of you may be looking forward to, that tax refunds make their way to taxpayers.

The Treasury employs a professional cadre of staff who forecast economic indicators and analyze market conditions in order to monitor risk building up in our financial system and promote not just an economic recovery, but sustainable economic growth.

The Treasury's special inspector general (IG) for the Troubled Asset Relief Program (TARP) works diligently to root out fraud and abuse in that program and provide transparency. Last year alone, the IG saved \$555 million in taxpayer dollars that would have otherwise been lost to fraud. The office continues to work, this year, on 153 criminal and civil investigations that they actively pursue.

To continue all these activities in 2012, the Treasury requests spending authority of \$1.39 billion. The request is actually a net decrease of \$18 million, or 1½ percent, compared to both the fiscal year 2010 enacted level and the fiscal year 2011 continuing resolution level that we're currently operating under.

I'm glad to see a restrained budget proposal, though I'm concerned about some of the proposed cuts. There are several that have come to my attention. The Treasury proposes to scale back local law enforcement access to data on suspicious financial transactions. There's also a proposal to discontinue funding for law enforcement pursuing criminal activity related to alcohol and tobacco. We'll discuss those today.

In addition to these ongoing duties, the Treasury is shepherding the creation of the Bureau of Consumer Financial Protection (CFPB). For too long, consumers have struggled to navigate financial products fraught with hidden fees, bait and switch terms, and other complex features that even experts have difficulty understanding. The CFPB will operate with a simple mission: to empower consumers with the information they need to make financial decisions for themselves and their families.

PREPARED STATEMENT

Since the day I introduced the first bill to create this bureau, Wall Street has fought it and tried to undermine it. In fact, with the help of some in the House, Wall Street is attempting to limit

spending by this Bureau to barely half of what it needs to get started. It's not a surprise that Wall Street is balking at the CFPB starting up. Fully informed consumers will make markets more competitive, eliminating the ability of banks, lenders, and mortgage brokers to profit from sheer confusion. We're going to work to make sure this agency has what it needs to start working for consumers from the start.

I look forward to discussing these and other issues with the Secretary.

And I now turn to my ranking member, Senator Moran, for any opening remarks.

[The statement follows:]

PREPARED STATEMENT OF SENATOR RICHARD J. DURBIN

Good morning. I am pleased to convene this hearing of the Appropriations Subcommittee on Financial Services and General Government, the first in a series of hearings I am planning this spring as we embark on developing our 2012 appropriations bill.

I welcome my ranking member, Senator Jerry Moran, and other colleagues who have joined me on the dais today. I also welcome Treasury Secretary Timothy F. Geithner to the hearing.

Today we will examine the fiscal year 2012 funding request for the Department of the Treasury. While the Treasury programs funded in our appropriations bill include the Internal Revenue Service (IRS) and the Community Development Financial Institutions (CDFI) Fund, we're planning to look at these two agencies in depth in separate hearings scheduled over the next several weeks. We'll save questions on the IRS and CDFI for those focused hearings.

The Treasury programs we'll examine today deliver a generous return on investment to taxpayers. I would like to illustrate a few examples of how Treasury programs provide taxpayers with the best bang for their buck.

Before any coalition planes were in the sky over Libya, Treasury's Office of Foreign Assets Control froze \$32 billion in Libyan assets. That's \$32 billion that Muammar Gaddafi can not use to pay mercenaries, gas up his tanks, or purchase weapons to fight his own people.

Treasury's Financial Crimes Enforcement Network (FinCEN) tracks the financial paper trail when a criminal tries to steal your identity, cash out the equity in your home, or skim your credit card, and again when that criminal tries to wire your money abroad, blow your money on blackjack, or even flee the country with a pocket full of diamonds. It's Treasury's FinCEN that follows the money to make sure crime doesn't pay for terrorist financiers, organized crime, narcotics traffickers, Ponzi scheme operators, and loan modification scammers.

Treasury's Financial Management Service ensures that Social Security payments make their way to our seniors, that benefit payments make their way to our disabled veterans, and—as many of you may be looking forward to—that tax refunds make their way to taxpayers.

Treasury employs a professional cadre of staff who forecast economic indicators and analyze market conditions in order to monitor risks building up in our financial system and promote not just an economic recovery, but sustainable economic growth and global competitiveness.

Treasury's Special Inspector General for Troubled Asset Relief Program (TARP) works diligently to root out fraud and abuse in the TARP program and provides transparency of a complicated program. Last year alone, the inspector General saved \$555 million in taxpayer dollars that would have otherwise been lost to fraud. The office continues its work this year with 153 criminal and civil investigations it is actively pursuing.

Treasury's Alcohol and Tobacco Tax and Trade Bureau collects more than \$24 billion in taxes on alcohol and tobacco every year with a budget of just \$103 million. The agency combats tax evasion, keeps illegal tobacco and alcohol products off the shelves, and ensures alcohol products are labeled properly and advertised appropriately. Every time you open a beer, a bottle of wine, or a bottle of spirits, you can trust the label because Treasury has ensured the safety of that product.

To continue all of these activities in 2012, Treasury requests spending authority of \$1.39 billion. The request is actually a net decrease of \$18 million, or 1.5 percent,

compared to both the fiscal year 2010 enacted level and the fiscal year 2011 continuing resolution level we are currently operating under.

While I'm glad to see a restrained budget proposal, I have some concerns about a few of the proposed cuts. Let me talk about a couple of them. Treasury proposes to scale back local law enforcement access to data on suspicious financial transactions. Treasury also proposes to discontinue funding for law enforcement pursuing criminal activity related to alcohol and tobacco. I look forward to discussing those proposals in more detail today.

In addition to these ongoing duties, Treasury is shepherding the creation of the Consumer Financial Protection Bureau (CFPB), known as the CFPB. For too long, consumers have struggled to navigate financial products fraught with hidden fees, bait-and-switch terms, and other complex features that even experts have difficulty understanding. The CFPB will operate with a simple mission—to empower consumers with the information they need to make financial decisions for themselves and their families.

Since the day I introduced the first bill to create such a bureau, Wall Street has fought to defeat and undermine it. In fact, with the House Republicans' help, Wall Street is attempting to limit spending by that agency to just half of what it needs to get started. It's not a surprise Wall Street is balking at the CFPB starting up—fully informed consumers will make markets more competitive, eliminating the ability of banks, lenders, and mortgage brokers to profit from sheer confusion.

We're going to work to make sure this agency has what it needs to start working for consumers right from the start.

I look forward to discussing these and other issues with you. I now turn to my Ranking Member, Senator Moran, for any remarks that he would like to make.

STATEMENT OF SENATOR JERRY MORAN

Senator MORAN. Mr. Chairman, thank you very much.

Secretary Geithner, welcome.

Today marks my first opportunity to sit in this new role as Ranking Member of the Financial Services and General Government Subcommittee, and I appreciate the opportunity to serve on the Appropriations Committee, particularly given its very important role in providing oversight over all discretionary spending.

I look forward to working with you, Mr. Chairman, as we review this budget, and others, and make certain that our agencies have the opportunity to explain their story and we reach the right agreement in regard to spending levels.

Mr. Secretary, you have many, many challenges, and your responsibilities are great, and they include, in my view, reinvigorating bank lending to consumers and small businesses, stabilizing the housing market, and encouraging sustainable economic growth. Most importantly, you must promote this economic growth at a time in which the long-term financial security of the United States is one that is burdened by unprecedented debt.

Our country faces enormous fiscal challenges which, left unchecked, will have a disastrous impact upon the future of our Nation. For too long, members of both political parties have ignored this growing fiscal crisis and allowed our country to live well beyond its means.

Americans are looking for leadership in Washington to confront the problems we face today and not to push them on to future generations. Oftentimes, the debate about Government spending is seen as a philosophical, academic, another political discussion, a partisan issue; but, in my view, the truth is that out-of-control borrowing and spending has very real consequences upon the everyday lives of Americans. We are facing a turning point in our country's history and can no longer avoid these difficult decisions.

Mr. Secretary, I know that you're fully aware of the crisis we are facing, and I hope that we can work together to right the ship. The Congress needs a partner in the administration if we are to enact any meaningful changes or reforms.

In my remaining few moments, I want to address another problem hampering our economic recovery: the uncertainty coming out of Washington, DC. regarding bank regulations and bank regulators. You and I had a conversation about this at a joint hearing when I was a Member of the House. And unfortunately, I don't think things have changed. We have reached a sad point in America when small-town banks are unwilling or unable to lend to small-town businesses. This sort of relationship banking played no role in the fiscal crisis we just experienced, and I feel strongly that, once we correct this trend, we will see a recovery take hold.

I hear, from many Kansas bankers, that the most serious reason for their inability to lend to creditworthy borrowers in the community—in their community—is the fear of bank examiners' unwarranted scrutiny and the increasing cost of unnecessary regulations. Time and time again, I hear from bankers, like I heard this morning, Ken Domer, of Spearville, Kansas, who, in his 30 years experience as a banker, has never experienced such an unprecedented examination process like what has been ongoing recently. I hope that you will work with me to find solutions to this circumstance.

Finally, I am requesting your thoughts—Senator Durbin mentioned the CFPB—I intend to introduce legislation today that would reform the structure of the CFPB by subjecting it to an appropriations process and replacing the single-director structure with a five-person commission, similar to the Securities and Exchange Commission, Commodity Futures Trading Commission, and a host of other Federal agencies. While my concerns with Dodd-Frank extend beyond the structure of the CFPB, this legislation, I believe, is a good first step to making sure the Congress has the necessary oversight of such a powerful agency.

Secretary Geithner, the Department of the Treasury plays an important role in managing the Federal Government's finances and attempting to reinvigorate our economy, and I stand ready to work with you to address the challenges, and look forward to working with you and Senator Durbin and my other colleagues on this subcommittee to find common-sense solutions to address our mounting fiscal crisis.

Senator MORAN. I thank the Chairman and welcome Secretary Geithner.

Senator DURBIN. Thank you, Senator Moran.

Mr. Secretary, you have the floor.

SUMMARY STATEMENT OF HON. TIMOTHY F. GEITHNER

Secretary GEITHNER. Thank you, Chairman Durbin, Senator Moran, and members of the subcommittee. Thank you for letting me come up here today and talk to you. And I appreciate both your opening statements.

We're here to talk about the Treasury budget, which, at first glance, may not seem central to the broad questions we're debating about how to strengthen the economy and restore fiscal sustain-

ability. But, I want to spend a few minutes at the beginning just highlighting what's at stake.

As you know, the Treasury plays a key role in a range of important programs to help strengthen economic growth. We play a central role in designing and administering a powerful set of tax incentives to encourage business investment and capital spending, investment in small, high-growth, start-up companies, make it easier for families to afford college. We play a central role in the evolving debate about how to design a better means for financing infrastructure across the country, in setting up a series of very important programs to help facilitate small business lending and credit growth, the new market tax credit, the CDFI program. We play a very important role helping expand United States exports, not just through our work with China, to encourage them to appreciate their currency more rapidly, but broader efforts to help us to establish a more level playing field for American companies. Obviously, we're playing a central role in helping repair the damage caused by the crisis to the housing market. And we're working to design a better corporate tax system that can help strengthen incentives for investment in the United States.

Second, beyond these broad questions about economic growth, of course, we're playing a critical role in helping reform our national financial system. We chair the council established by the Congress for financial stability. We're helping work to wind down the government-sponsored enterprises' fixed housing finance system established by the CFPB, bring oversight to derivatives markets, all as part of a broad strategy working with countries around the world to make sure that U.S. firms face a level playing field as we strengthen these basic constraints on risk taking and leverage.

The Treasury plays a key role, as the Chairman said, in help protecting our national security through administering our terrorist financing sanctions programs, not just with Iran and North Korea, but, as the Chairman said, most notably and recently, Libya.

The Treasury, as you know, is responsible for raising the resources required to fund the obligations the Congress has established for the Government and for helping Americans meet their obligations as citizens. Every \$1 we spend at the IRS helps generate nearly \$5 in tax revenue. Every \$1 we cut in enforcement through the IRS will increase our future budget deficits, add to our debt, and increase the risk that Americans who pay their taxes, pay more than their fair share of the burden.

Now, we carry out these responsibilities with a very tight, efficient use of taxpayer resources, a very lean and talented, dedicated staff of professionals at the Treasury. You know, it's a remarkable achievement that, in a \$14 trillion economy at a time of severe economic and financial crisis, enormous economic challenges here and from around the world, that the entire main Treasury staff, what we call the departmental offices, is about the size of a tax department at one of America's single iconic corporations.

We play a lead role in the executive branch in helping find ways to save resources. Let me just cite two examples that are highlighted in my testimony.

Within the Treasury, we've identified, in our last three budget requests, more than \$1 billion in savings by consolidating functions

and helping bring the Government payment system into the modern era by shifting to electronic processing of payments, paperless transactions. And with very careful management of the emergency programs established by the Congress to resolve our financial crisis, we have helped save hundreds of billions of dollars of taxpayer resources through the careful management of those investments. As you know, our overall investments in the banking system alone are likely to generate a very substantial profit to the American taxpayer, estimated, today, in the range of \$20 billion.

Now, the President and the congressional leadership are meeting this morning on the budget for this year. Of course, we're 6 months into the year now. House Republicans outlined, this morning, a proposed strategy for how we reduce our deficits over the long term. A group of bipartisan Senators are working hard to reach agreement on a comprehensive, multiyear set of reforms to put us on a path back to living within our means as a country.

So, I want to just conclude by emphasizing how important it is that we reach a bipartisan agreement on how to restore fiscal sustainability by reducing spending where we can, but still investing in the types of reforms, like education, that are essential to our economic future, and by enabling us to meet our commitments to our seniors and those less fortunate Americans.

The economy is healing, job creation is accelerating, businesses are investing, but we have a long way to go to heal the damage caused by this crisis, and we face enormous challenges, including from—countries new competitors around the world. So, I think all of us in Washington have a responsibility to demonstrate that we can solve these problems, not just talk about them.

PREPARED STATEMENT

So, I look forward to working with you, and I appreciate very much your support for the exceptionally talented and professional staff of the Treasury that carry out such an enormously complicated set of responsibilities.

[The statement follows:]

PREPARED STATEMENT OF TIMOTHY F. GEITHNER

Chairman Durbin, Ranking Member Moran, members of the subcommittee, thank you for the opportunity to testify about the President's fiscal year 2012 budget for the Department of the Treasury.

The Congress has given the Treasury a very broad mission, with responsibilities that touch many aspects of the lives of Americans.

The Treasury is responsible for raising the resources necessary to fund critical Government functions, from national defense to protecting national parks. As the Government's financial manager, we process payments on a daily basis of almost \$100 billion, including Social Security payments to 54 million Americans each month. We design and deliver tax credits to help support business investment and help families finance a college education. We design and enforce the financial sanctions necessary to prevent the spread of nuclear weapons and the finance of terrorism.

The Treasury plays an important role in helping shape the President's overall economic policies. Our lead policy responsibilities include tax policy, international economic policy, and the stability of the U.S. financial system, which is the focus of the recently established Financial Stability Oversight Council that I chair.

Unlike most Federal agencies, the Treasury's annually appropriated budget is about people more than programs, with most of the resources we seek from the Congress directed to supporting the talented public servants charged with these important economic and financial responsibilities. Salaries and operating costs make up

96 percent of our budget, and most of the rest is for investments in technology they require to function.

In the President's budget for fiscal year 2012, the administration requested slightly more than \$14 billion, \$13.3 billion of which is for the Internal Revenue Service (IRS). This request includes efficiency savings and program reductions across all Treasury bureaus, as well as a number of targeted investments to allow us to better address some of the most important economic challenges facing the United States.

Let me begin by summarizing the core economic and financial priorities that shape this budget request.

STRENGTHENING ECONOMIC GROWTH

As we work to strengthen the economy and help get more Americans back to work, we are responsible for a range of initiatives designed to help support business investment.

As part of the Small Business Jobs Act of 2010, the Treasury is implementing two new programs—the Small Business Lending Fund and the State Small Business Credit Initiative—designed to improve access to capital for small businesses.

We are working to encourage private sector investment in start-ups and small businesses operating in moderate and low-income communities through investments in the Community Development Financial Institutions Fund and the New Markets Tax Credit Program.

ASSISTING HOMEOWNERS AND REPAIRING THE HOUSING MARKET

In the face of the worst housing crisis in a generation, the Treasury plays an important role in the Government's programs to prevent avoidable foreclosures and support the continued repair of the housing market.

The Treasury's Home Affordable Modification Program (HAMP), which is one of several critical homeownership assistance programs under our Making Home Affordable initiative, has helped more than 630,000 families stay in their homes. By setting affordability standards and providing a framework for homeowner assistance that the private sector can follow, HAMP has also driven industry improvements that have resulted in 2 million additional modifications outside the program. We continue to refine and strengthen our housing programs and are taking additional steps to help ensure Americans are better served by their mortgage companies, including publishing a quarterly compliance scorecard for each of the 10 largest HAMP servicers and requiring all Making Home Affordable participating servicers to assign a single point of contact to each homeowner requesting a HAMP modification.

Another key priority is comprehensive housing finance reform. In February, the administration laid out a plan to wind down Fannie Mae and Freddie Mac and reform our Nation's housing finance system. We look forward to working with the Congress in the coming months to develop legislation that will help create a safer and more stable housing finance market.

REPAIR AND REFORM OF THE FINANCIAL SYSTEM

Our programs to help strengthen and reform the financial system have made very substantial progress, but we still face a number of challenges ahead.

The financial recovery bank programs under the investment portion of the Troubled Assets Relief Program (TARP) are now estimated to provide a substantial positive return to the taxpayer. On March 30, we announced that TARP's bank programs officially turned a profit. Moving forward, we're working to exit our remaining investments and continue recovering taxpayer dollars. Ultimately, we expect TARP's bank programs will produce a lifetime profit of nearly \$20 billion.

We are also continuing to work in cooperation with the Federal Housing Finance Agency to protect taxpayers and reduce the ultimate cost of the Government's support for the housing market through the Government Sponsored Enterprises (GSEs). In the President's fiscal year 2012 budget, the net cost of rescuing Fannie Mae and Freddie Mac is projected to drop by 44 percent from \$131 billion today to \$73 billion over the next 10 years as those companies continue to pay back dividends on the Government's investment. In fact, in each of the last two quarters, the net cost of the Government's investment in Fannie Mae and Freddie Mac has declined, because those firms have paid more back in dividends than they have requested in new funding.

We are helping shape the rules to implement the comprehensive reforms to the financial system passed by the Congress last year, including stronger protections for consumers and tougher limits on risk-taking by banks. These reforms will help

make our financial system more secure and protect the American taxpayer, but to be effective we need to fully fund their implementation and enforcement.

TAX REFORM

The President has proposed to reform our corporate tax system to make America more competitive.

We look forward to working with Members of Congress and the business community to design a comprehensive, revenue neutral reform of the corporate tax system that would lower tax rates, eliminate special tax breaks, and encourage investment in the United States.

PROMOTING U.S. ECONOMIC AND NATIONAL SECURITY INTERESTS GLOBALLY

The Treasury plays a critical role in helping advance U.S. economic interests abroad and protecting against foreign threats to our economic and financial security. Our request sustains the Department's investment in counterterrorism and financial crime programs. This includes funding for implementing targeted economic sanctions against foreign threats to the United States and stopping the flow of money to terrorist organizations and their support networks.

IMPROVING THE EFFICIENCY OF GOVERNMENT SERVICES

As we pursue these core priorities, we are working to deliver savings, program reductions, and improvements in the overall efficiency of government. As a result of these savings, our budget requests for fiscal year 2012 in five accounts are below the fiscal year 2010 enacted levels, and in three accounts are below the fiscal year 2008 enacted levels.

Taxpayer Services and Tax Enforcement

The customer service and enforcement programs at the IRS provide one of the best values in the Federal Government. Every \$1 invested in IRS yields nearly \$5 in increased revenue from noncompliant taxpayers. The targeted investments in this budget request are expected to produce more than \$1.3 billion in additional annual revenue once fully implemented in fiscal year 2014.

In fiscal year 2010, the IRS enforcement efforts brought in \$57.6 billion in additional tax revenues. This is a 53 percent increase in enforcement revenue since 2003 and a clear example that the investment in the IRS over the past few years is producing significant returns.

Over the last decade there have been nearly 4,500 changes to the tax law, providing IRS with a challenging and constantly changing business environment. Despite this fact, service levels have increased and each year the IRS has delivered a successful filing season.

The IRS continues to implement information programs and online applications to help taxpayers find and understand information. Use of the popular IRS Web tool, "Where's My Refund.com" has nearly tripled since 2006 to 67 million users. This modernization has not only helped improve IRS' daily interactions with taxpayers but has also provided the platform for significant productivity increases in IRS operations.

Today, we receive nearly 100 million tax returns electronically each year. In the past these returns would have been opened, sorted, and transcribed manually. Last year, nearly 70 percent of individual tax returns were filed electronically compared to a mere 10 percent 15 years ago. The efficiency savings have allowed us to consolidate 10 submission processing sites into six and reduce the need for manual submission processing jobs. We will repurpose an additional processing site later this year.

Our information technology modernization effort will decrease the time it takes to process and post-taxpayer information from 2 weeks to 1 day, allowing the IRS to issue faster refunds and customer service representatives to answer taxpayer questions based on more up-to-date information.

The Treasury's Electronic Payments Initiatives

Modernizing processes and reducing waste are key components not only of the IRS portion of the Treasury's budget but also of our overall efforts to make sure the Department operates more efficiently and effectively.

The Treasury now makes 82 percent of its payments electronically. We are taking action to further increase electronic payments. Effective May 2011, all newly enrolled Federal beneficiaries will receive payments electronically. By March 2013, we plan to move all existing beneficiaries to electronic payment.

Productivity increases have already allowed the Financial Management Service to repurpose the Austin, Texas payment center as a debt collection center. Debt collec-

tion efforts last year alone totaled more than \$4 billion, a 41 percent increase over fiscal year 2000.

Automation of our debt financing functions has allowed the Bureau of Public Debt to decrease staffing by more than 20 percent over the last 5 years. Additionally, we transitioned to an entirely electronic process for issuing payroll savings bonds earlier this year.

We are working to further automate debt financing.

In early 2012, we will no longer issue over-the-counter paper savings bonds. Instead, we will focus on supporting electronic means to issue bonds to individuals, reducing the cost of staffing, postage, paper forms, and processing fees.

Overall, these efforts to increase the Treasury's paperless transactions with the public are expected to produce more than \$500 million in cost savings and efficiencies over the next 5 years. These savings, which include reductions in personnel and facilities costs, will create a more efficient Department and allow us to increase the quality of the services we provide.

Reducing Fraud and Improper Payments

The Treasury will also expand upon and maintain the administration's VerifyPayment.gov portal to prevent ineligible recipients from receiving payments from the Federal Government. The Treasury will also continue to improve the management of the delinquent debt portfolio by implementing reforms that will increase collection of delinquent tax and nontax debt, including child support, by more than \$5 billion over the next 10 years.

Overall Improvements in Efficiency

The Treasury will cut the number of data centers we currently maintain by one-third by 2015, resulting in significant dollar and energy consumption savings.

These overall savings build on substantial improvements over the last 2 years.

The Treasury's fiscal year 2009, fiscal year 2010, and fiscal year 2011 budgets collectively included a total of more than \$1 billion in savings and offsets. The Treasury's fiscal year 2012 budget alone identifies nearly \$1 billion in savings, including \$336 million in direct cost savings and efficiencies and \$630 million in offsets primarily from assets seized as a result of violations of U.S. sanctions.

These savings allow us to finance some very important investments. Any substantial cut to the IRS budget will hurt revenue collection and service to taxpayers, resulting in unanswered phone calls and letters. Cuts to the remaining Treasury responsibilities would weaken our ability to support reforms that are critical to economic recovery and repair of the financial system. Cuts to the Community Development Financial Institutions Fund program would limit our ability to attract private investment to communities hit hardest by the economic crisis.

To carry out the Treasury's responsibilities, we need to be able to retain and support the dedicated public servants that make up the career staff of the Treasury and its Bureaus.

These are a very talented group of people, working extremely hard in the face of the most challenging economic and financial problems in many decades. They have played a vital role in helping restore economic growth and a measure of financial stability.

I look forward to working with you to ensure we continue to attract and retain a diverse, highly skilled workforce that delivers enhanced results for the American public.

Senator DURBIN. Thank you, Mr. Secretary.

I've been notified by the staff that Senator Lautenberg has an opening statement. And I'll extend the same courtesy to Senator Kirk, if he would like to make one.

STATEMENT OF SENATOR FRANK R. LAUTENBERG

Senator LAUTENBERG. Thanks, Mr. Chairman.

Little could be more important than to view where it is that we are and where it is we're going.

Welcome, Secretary Geithner.

We learned, last week, that that the Nation's jobless rate hit a 2-year low in March, another sign that the economy is continuing its slow but steady recovery.

And if I may add a personal note here, the company I ran before I came here is the company that releases the labor statistics that we see, a company called ADP. Yesterday, I'll take another moment of personal privilege—we said goodbye to my—to the founder of ADP—a partner, a humble man who worked very hard and created a company that today has 45,000 employees. We did it from nothing—nothing to help us along except our intelligence and our muscle. And I'm not sure that I provided much of the intelligence.

Right now, we've got to help Americans get back to work. That's got to be our top priority. And that's why I was pleased to see President Obama's budget call for critical investments we need to spark job creation. But, we can't make those investments if we don't start paying more attention to the revenue side in the Government's ledger. I was a CEO for many years, and I know that you can't run a company, or a country, without revenues. No matter how much you cut expenses, if you don't increase the revenues, you're headed for disaster.

And that's why I voted, last year, to end the Bush tax cuts for the top 2 percent of wage earners. Windfalls for the wealthy don't create jobs, reduce the deficit, or help us invest in our future. And I urge President Obama to keep the commitment in his budget to let the Bush tax cuts for the wealthy expire at the end of 2012, because if the wealthiest among us don't pay their fair share, we'll be denying children and grandchildren the future that they deserve.

The President's budget also funds the landmark Wall Street reforms that we passed last year. This new law will protect our economy from the kind of meltdown we suffered through in 2008. And that's why I'm deeply concerned that the Tea Party Republican plan to cut funding for reform is in place. If the Republicans—Tea Party Republicans succeed, Wall Street could return to its reckless ways, which will threaten our economic recovery and undermine our ability to create jobs.

We also need to strengthen investment in our Nation's infrastructure by repairing crumbling roads and bridges and building much needed new projects like high-speed rail. Construction of a 21st century rail system will make it easier for people to get where they need to go, improve our environment, and spark job creation.

President Obama has proposed creating an infrastructure bank to invest in projects that will—projects that will get America moving. And I look forward to hearing your commentary, Mr. Secretary.

I'm also eager to hear from the Secretary about how we can make taxes fairer, keep Wall Street in check, and accelerate our economic recovery.

Senator LAUTENBERG. And I thank you, Mr. Chairman.

Senator DURBIN. Thanks, Senator Lautenberg.

Senator Kirk.

Senator KIRK. No opening statement, thank you.

Senator DURBIN. Thanks a lot, Senator Kirk.

FINANCIAL MANAGEMENT DURING BUDGET UNCERTAINTY

Mr. Secretary, before we get to important policy and budget questions, I have to address the issue of crisis management. We

have been lurching from short-term continuing resolution to short-term continuing resolution. And I would like to ask you if you would tell me what impact this has had on the management of your agency and operations.

Second, we are now starting to have very active discussions among Senators about what to do if the Government shuts down after Friday—how many staff will still be around, whether anyone will answer the phones, whether there will be a skeletal staff or more. And I'd like to know what your preparations have been at the Department of the Treasury, and what services might be affected, from your Department, when it comes to that.

The final question is larger than the first two, and that is: Around the corner is another looming crisis, which you spoke of yesterday, and that is the extension of the debt ceiling. Some Senators have already come to the floor and said, flat out, "We don't care. We're not going to vote for an extension of the debt ceiling." Please tell us what the impact of failing to extend the debt ceiling would be on the American economy.

Three very simple questions.

Secretary GEITHNER. Mr. Chairman, thank you. Very consequential questions.

The Office of Management and Budget (OMB) has been coordinating the work of the executive branch in preparing for a shutdown. I think the Director of the Office of Management and Budget, Jack Lew, sent to the agencies, yesterday, a set of detailed guidance for how they would manage through, what critical services they would have to retain, would be permitted, under the law, to retain, and which they could no longer function with. I just want to emphasize that, confidence is very important to economic recoveries. There are a lot of things happening in the world today that carry some risk to the global economy and financial system. It is very important that we in Washington demonstrate that we are going to be doing things that are going to help reinforce confidence, support recovery. And part of that requires making sure that Government can carry out its critical functions. And those functions would be impaired during a shutdown.

We would be happy to brief your staff in more detail on exactly what would happen for the critical functions we're responsible for at the Treasury, but let me just say, they're very material.

Now, you're right, of course, to highlight the fact that to say it again, if we force the Government to live week by week now, more than 6 months into the fiscal year, we risk undermining the recovery now underway. And I think our first obligation to the American people, given the trauma still caused by this crisis and the depth of the damage we still face, is to make sure we're doing everything we can to ensure that we're reinforcing business confidence, helping get more Americans back to work, repairing the damage caused by the crisis—a shutdown will get in the way of that, of course.

Now, you're right to say that, in the next several weeks, the Congress will run out of room. Under the debt limit, it will be forced to raise the basic debt limit. You asked the question, "What happens if we do not? If the Congress does not raise the debt limit?" As I said in my recent letters, and as all my predecessors have said, the consequences of that would be catastrophic to the United

States. Default by the United States would precipitate a crisis worse than the one we just went through. I think it would make the crisis we went through look modest in comparison. It would force us, of course, to cut payments to military, cut critical payments to our seniors. And it would be a reckless, irresponsible act of this country. I find it inconceivable that the Congress would not act to increase the limit.

I welcome that all the leaders of both parties, in both houses of Congress, have reaffirmed the importance of making sure that this country, the United States of America, will meet its obligations. Of course, that requires the Congress to act in a timely manner to increase the limit.

If we take no additional actions, we face that—we run out of room on May 16. There are a series of measures my predecessors have used in the past, that the Congress has authorized, that would give the Congress a little bit more time, but those measures don't buy us nearly as much time as they did in the past, because our debt and deficits are so large now. So, they will buy us an additional few weeks if the Congress doesn't act.

Now, of course, even resorting to those measures does create some risk of adding to uncertainty in the markets. So, you don't—you'd rather us not do that. But, we'll do everything we can to make sure that we meet our obligations, and, of course, encourage the Congress to act in a timely manner.

DEBT CEILING AND ECONOMIC CONSEQUENCES

Senator DURBIN. Let me ask you this question, Mr. Secretary. The United States Dollar is viewed as the most credible global currency, and if we default and don't extend our debt ceiling, what impact could this have on the reputation of the dollar and our economy?

Secretary GEITHNER. Again, it would be catastrophic. If you call into question the willingness of the Government of the United States to meet its obligations, you will shake the basic foundations of the entire global financial system. It is inconceivable that America would do that. And I'm—of course, I'm totally confident that the Congress will act to avoid that.

But, you know, again, to think about it in a direct sense, what it does is, it will raise, dramatically, the borrowing cost, permanently, for all Americans. Every business, for a very long period of time, would raise a much higher cost of borrowing. Every family would raise a higher cost of borrowing. Unemployment would rise dramatically. Thousands, if not hundreds of thousands, of businesses would fail. And, of course, you would shake the confidence of the world in U.S. financial assets and treasuries. It would be a deeply irresponsible act. Again, inconceivable.

Senator DURBIN. Thank you.

Senator Moran.

Senator MORAN. Mr. Chairman, thank you.

Mr. Secretary, I appreciate your exhortation about the necessity of raising the debt ceiling, and the consequences that you describe would occur. I also would welcome you and the administration raising the same kind of concerns in describing the scenario that will occur if we do not get our debt under control. There are con-

sequences to the value of the dollar, to the standard of living, to inflation. And I very much, again, would encourage the administration to join with the Congress—Republicans and Democrats—to find a path toward a long, sustainable reduction in our national debt. There are bad consequences—you certainly described one scenario of events, but there's another scenario that will come if we do not respond appropriately, responsibly, to the ever increasing debt.

TAX REFORM AND CFPB FUNDING AND STRUCTURE

One of the things we can do, in addition to cutting spending, is to get a tax code in place that is fair, that treats American business and individual taxpayers in a way that makes sense in a global economy and, again, would—I'd be interested in hearing what the Treasury Department is doing in regard to the so called grand plan for tax reform, or major modifications in our tax code.

I'm learning from Senator Durbin to ask all my questions at the very beginning, so that the clock is on your time, not mine.

And finally, a much more specific one. I indicated, in my opening statement, that I'm introducing legislation today in regard to the board of the CFPB. And I'd like your view as to the appropriations process. You're funding that—the Federal Reserve is funding that today. I'd like to see greater oversight by the Congress in regard to the appropriation process—a five-person commission or board, as compared to an individual. And then, perhaps most importantly, can you tell what the administration's timeline is for submitting a nomination to the Senate for the person to head that bureau?

Secretary GEITHNER. Excellent questions. Thank you for raising them.

Of course, you're absolutely right that it is critically important, as I said in my opening statement, that the Congress come together, on a bipartisan basis, and lock in a set of multiyear reforms that put us back on a path to living within our means as a country. That's very important to future economic growth. There is no alternative to doing that. It's very important. If we don't do that, you're right, you would put at risk future economic growth. And we need to come together. We can't keep putting it off indefinitely.

You have before you a—not just a process under way by a group of bipartisan Senators, but looking at a comprehensive plan that the fiscal commission which Senator Durbin served on, which is a very comprehensive, very balanced, reasonable starting point for discussion. You know, this is not beyond our capacity, as a country, to solve. In fact, if you look at how the world views the United States today, the world investors are very confident we're going to solve this problem. But we have to earn that confidence. We have to justify that confidence. And that requires us acting. And you're right to emphasize it. I completely agree with you.

You asked about tax reform. I think it's inevitable that the Congress and the administration come together and reform, comprehensively, the U.S. tax code, not just for individuals, but for corporations. You have a very compelling model for doing that, in the Commission's proposal—a lot of merits in that basic approach, which is to broaden the base and use some of the savings from broadening the base to lower rates and lower future deficits. We

are—as I said in my opening statement, we are designing a corporate tax reform that’s comprehensive, that would lower the statutory corporate rate very substantially, and pay for that by reducing or eliminating a set of special preferences for individual industries and activities of the United States. We think that’s absolutely necessary to improve incentives for investment in the United States. And we’re hopeful that we’re going to be able to work with the Congress on doing that, perhaps ahead of the comprehensive reform of the individual code, which is likely to come—I think it’s going to have to come in the next few years.

And again, that’s very important, because we want to do everything we can to make it more likely that American companies build their next plant in the United States and that foreign companies build their next plant here, too. And tax incentives are important to that.

Senator MORAN. Mr. Secretary, in addition to the National Commission on Fiscal Responsibility and Reform, does the administration—is there a plan in the works on corporate tax?

Secretary GEITHNER. Yes. We have been working on a comprehensive proposal to help get the process in the Congress moving. And we’ve been consulting closely with your colleagues on the tax-writing committees about how to design that, and with the business community. And I’m actually quite optimistic we’re going to be able to start that process with a very strong pro-investment, pro-growth, pro-competitiveness proposal.

Now, it, of course, is going to have to be revenue neutral, given the broader fiscal challenges we face, but I think we can do that.

Now, you raised a set of important questions about the CFPB. I can’t answer your last question, which is, “How soon are we going to nominate?” But, of course, it’s very important that we nominate and confirm a director, because the full authorities the Congress gave this bureau do not come into place until we have a confirmed director. Some happen in advance of a confirmed director, but not all. And so, obviously, we’d like to do that. We’re consulting with the Congress. We want to nominate somebody who can be confirmed. That is why it’s taking us a little bit of time. As you know, it’s been a challenge for us to find—to confirm a number of positions for important financial responsibilities.

You said you were going to propose legislation to establish a different set of checks and balances on the bureau. And, of course, I understand that motivation. But, I believe, as you would suspect, that the Congress, having considered a range of alternative models, came up with a very good model that combines strong authority and independence with a set of very powerful checks and balances. The most powerful of those in this structure are that the decisions of this bureau are subject to review and approval by the Council of Financial Supervisors and Regulators that the Congress established. That creates, in some ways, a stronger set of checks and balances than I think exists for many other financial regulators, independent or not; and I think the Congress got that balance right.

Again, of course, if you look at what happened in our country in this crisis, you saw really appalling, unforgivable failures in consumer protection. It is very important that we fix that. And I think

the Congress, you know, thinking about it for a long time, a lot of difficult debates, came up with a good balance.

Senator MORAN. If I could follow up, Mr. Chairman? Thank you.

Can you think of any downside to not having a director confirmed by the operation date in July? Is that—

Secretary GEITHNER. Absolutely. You know, what happens at what we call the transfer date, which is a date where the authority that exists among existing Federal agencies for consumer protection is transferred to this new bureau. You know, that responsibility is shared among, I think, seven different Federal agencies. So, we're going to centralize that, consolidate that. But, there are other authorities to write rules that only take effect when there's a confirmed director.

And now let me tell you about the consequences of that delay. I think one of the biggest problems we had in our system was, we held banks to a set of standards, no similar standards established for entities that provide consumer finance, lent to individuals without protection. So, what happened over time is, a lot of that basic business of consumer finance moved outside the banking system to nonbank financial institutions that were not supervised adequately. And that created, of course, appalling vulnerability to fraud and predation for individuals, but it also created this huge unfairness for banks— for community banks, as well. So, one of the most important things the Congress did is to say, "We're going to establish a level playing field across banks and nonbanks so that the business can't just shift to where there's no regulation. And if we delay, we starve funding or delay full powers for the agency, then you're going to be putting banks at a disadvantage again. And they're going to face again the possibility of having that business competed away by entities that aren't subject to oversight and supervision. So, that would be an unfortunate consequence of delay.

Senator DURBIN. Senator Lautenberg.

Senator LAUTENBERG. Thanks, Mr. Chairman.

ECONOMIC CONSEQUENCES OF A GOVERNMENT SHUTDOWN

Mr. Secretary, might a consequence of a shutdown result in an inflationary reaction?

Secretary GEITHNER. I think that's an excellent question. And I don't think I would frame that as the most significant risk. I think the most significant risk is that you leave entities that are doing vital things, not just supporting Americans in combat, not just making payments to seniors, providing benefit checks that Americans depend on for their living, processing tax returns—you put those things at risk. The risk is, for a long period of time, you create uncertainty, and that could slow momentum of recovery. So, I would think—not about a risk that we accelerate inflation so much as what we do is, we take a little bit of the momentum, the wind, out of the recovery, and therefore slow the pace of getting more Americans back to work.

BUSH'S TAX CUTS

Senator LAUTENBERG. House Republicans claim that cutting programs like Head Start and medical research is going to solve the deficit problem. But, they refuse to look at the revenue side of

things. I mentioned that earlier. And how important is it to, for instance, let the Bush tax cuts for the wealthy expire at the end of next year to help to eliminate the budget deficit?

Secretary GEITHNER. It's critically important. I'll give you an example of how to—if the Congress extends those tax cuts that go to 2 percent of the most fortunate Americans in the country, we have to go borrow \$1 trillion over 10 years. It's those, plus the estate tax exemptions. We cannot afford to do that. It is not a responsible act of Government, of asking my successors to go out and borrow \$1 trillion over 10 years to finance tax cuts for the richest 2 percent of Americans. We cannot afford it. There's no credible case for doing it.

And you cannot restore fiscal sustainability—you cannot restore a modicum of balance to our fiscal position and still preserve our capacity to invest in things critical to U.S. economic growth and critical to our commitments to our seniors if you sustain those tax cuts that we cannot afford.

FUNDING FOR WALL STREET REFORM

Senator LAUTENBERG. The administration's budget calls for increased funding for agencies implementing the Wall Street reform law. House Republicans failed in their attempts to block this historic law. So, they proposed, instead, to cut the funding for these agencies. In your capacity—you're head of the Financial Stability Oversight Council—what effect might these proposed cuts have on Wall Street reforms and our ability to prevent another financial crisis?

Secretary GEITHNER. Well, I think you said it right. Those—the cuts are designed to starve those agencies of the ability—deny them the ability to enforce a set of basic, sensible protections for consumers and investors. And if they were passed, they will have that effect.

I'm confident they won't pass, because we think it would be irresponsible to pass them. But, if they did pass—become law—they would have that effect of depriving us of the ability to fix what we got so devastatingly wrong, at enormous cost to the American people, a financial crisis, you know, without recent precedent, enormous damage to the country. And so, I think it's very important the Congress equip the executive branch and the regulatory agencies with the resources and the people we need to enforce those basic, sensible rules of the game.

SANCTIONS ON LIBYA

Senator LAUTENBERG. Mr. Secretary, yesterday you lifted the sanctions against former Libyan Foreign Minister Moussa Koussa, a man who's been linked to numerous terrorist attacks, including Pan Am 103, which killed 270 people, 189 of whom were Americans. In your consultation with Secretary Clinton regarding lifting these sanctions, did you discuss what other levers might be available to be sure that he's held accountable for these crimes?

Secretary GEITHNER. I know my colleagues in the national security community have discussed that, and I'd be happy to talk to them, pass on your concern and question, and ask them to come talk to you about how we can be responsive to your concern.

DEFICIT REDUCTION

Senator LAUTENBERG. What would the estimate be of the revenues needed to help us stabilize things and continue looking to improvements in our economy?

Secretary GEITHNER. Well, the central question we face is how to get the deficits down to a level where we put our national debt, as a share of the economy, on a declining path. You have to first stabilize it at an acceptable level, and then you have to start to reduce it. And that requires we get our fiscal deficits down to a level below 3 percent of the gross domestic product. That's a level at which our revenues and our commitments, apart from interest, are in balance.

Now, to do that—we proposed, in our budget, a way to do that. You have, in the Commission proposal, a more ambitious way to do that. But, that provides—both those examples provide a package a balanced package of tax reforms and reductions in spending and our commitments that would achieve that measure of balance without putting at risk future economic growth, without causing material damage to the economy. Those are things we can—changes we can afford to make, changes that we can accept. And both those examples give you a measure of what you want to do to make sure you have a balanced package.

Again, the challenge is not to just reduce the deficit. The challenge is to do it in a way that doesn't hurt future economic growth and hurt investment in the United States, is fair to the American people—judged as fair as—the American people. And that requires you do it in a balanced, comprehensive way. I think it's within our capacity to do, as a Nation. I think this is something we should make sure we let Americans know, because they're uncertain about this, that this is something we can do at acceptable costs, with time for people to adjust.

Senator LAUTENBERG. Well said, Mr. Secretary. Thank you.

Senator DURBIN. Senator Kirk.

Senator KIRK. Thank you.

FUNDING FOR TREASURY'S INTERNATIONAL PROGRAMS

I want to turn to your budget request. You requested a 4 percent increase. And a couple of accounts stood out. There's a request for \$3.4 billion for the Treasury international programs, which was a 58 percent increase more than fiscal year 2011. And then food security accounts was a 1,027 percent increase request in your budget. And debt relief was a 336 percent increase in your budget. Can you review, quickly?

Secretary GEITHNER. Absolutely. You know, usually I testify separately on the international piece of our budget. The Treasury piece of the—what's called the foreign assistance budget is about 5 percent of the total foreign assistance budget. And our piece, the piece we're responsible for, is for funding the institutions, like the World Bank, the international financial institutions. And in those institutions, we get enormous leverage for every \$1 of taxpayer resources.

The specific request you refer to includes a variety of commitments that the Government of the United States made in the past, under Republican and Democratic administrations, and a set of

new commitments targeted in areas where we think there's the highest return to our basic national security and economic interests.

I'll give you an example. In food security, what we've proposed to do is to help seed a multilateral fund to help support improvements in agricultural productivity and investment in developing countries, because, of course, the enormous challenges of poverty in those countries. But, that's also an example where there's a very high return to American technology and American innovation, because we're the most productive farmers in the world.

I'd be happy to talk in more detail to you and your staff about that. But, it's worth noting, we're 5 percent of the foreign assistance budget, but our resources in that 5 percent leverage multiple dollars, both by bringing other people to the table and borrowing. And so, the total resources that 5 percent supports is more than one-and-a-half times the entire 150 account budget.

So, as we figure out how we reduce spending and reduce our deficits—and we're going to have to reduce spending—we want to make sure we're preserving things where we have the biggest bang for the buck, the biggest improvement, the biggest return on the marginal dollar taxpayer resources. And that's what our request provides.

Senator KIRK. I'm worried—we have appropriated money that apparently is going directly to the Islamic Republic of Iran under your administration, meaning that the Treasury Department manages our relationship with the International Bank for Reconstruction and Development (IBRD), International Finance Corporation (IFC), and Multilateral Investment Guarantee Agency (MIGA). The IBRD has a \$344 million unexpended balance to Iran. Since we own 16.8 percent of the bank, that's 58 million United States dollars that would be provided to Iran. The IFC—\$17 million, since we own 24 percent. That's 4 million U.S. dollars from the taxpayer. The MIGA are going to provide \$127 million to Iran. We own 18.5 percent of that. It's a total of \$85 million, direct from the U.S. taxpayer. And I understand these payments are made directly to the Finance Ministry of the Islamic Republic of Iran. Is that about right?

Secretary GEITHNER. Senator, you and I are in the same exact place in this, we oppose lending by the World Bank and its entities to Iran. We have opposed them for a long period of time. And the last loans that were approved by the World Bank board were approved in 2005.

Senator KIRK. I guess what I'm talking about is, you haven't cut these checks yet, but you're about to.

Secretary GEITHNER. Well, I'm not sure which checks you're referring to. Again, there—

Senator KIRK. These are 2005 loans—

Secretary GEITHNER. Yes, 2005 loans. That's the last time the World Bank approved a loan. We opposed—

Senator KIRK. Yes.

Secretary GEITHNER [continuing]. That loan then—

Senator KIRK. No, but I what I'm saying is—

Secretary GEITHNER [continuing]. And fought against it over that period of time, and, of course, as you know, working very, very

hard to dramatically tighten the financial sanctions on Iran now—

Senator KIRK. Yes.

Secretary GEITHNER [continuing]. With substantial success.

Senator KIRK. Let me just say, you do not have substantial success. I have written you a classified annex, and I hope you read it, a very—before you testify again, on this subject, I hope you read that very carefully.

Secretary GEITHNER. Of course I would. And again, I'd be happy—I know that you—I know you care a lot about these issues, as we do. And I'd be happy to talk to you in more detail about it. But, I will say again that the financial sanctions programs that my colleagues have helped us design, in cooperation with the national security community, have resulted in a dramatic, incredibly powerful tightening of the basic economic sanctions on the Government of Iran.

Senator KIRK. With all—

Secretary GEITHNER. It's very important we do that.

Senator KIRK. With all due respect—

Secretary GEITHNER [continuing]. And we will continue—

Senator KIRK. I urge you—

Secretary GEITHNER [continuing]. To look for ways to tighten it further.

Senator KIRK. Before you testify before the Congress again and make a statement like that, I would absolutely urge you to review the record.

Secretary GEITHNER. And again—and we're happy to work with you and your colleagues in ways to go further. And we—of course, this job requires a relentless focus, because, when we tighten something here, what happens is, over time, unless you stay on it, it—the stuff will shift gradually; people get around it. So, it requires relentless focus. Happy to talk to you in more detail about it.

FEDERAL DEBT AND ECONOMIC CRISIS

Senator KIRK. In March, the U.S. Government raised a net of \$128 billion and it spent a net of \$1.05 trillion, meaning your spending-to-raising ratio was—you spent \$8 for every \$1 that you raised. You covered it by borrowing \$786 billion and reducing your cash balance \$72 billion, to an ending balance, for the U.S. Government, of \$118 billion in the bank. Is that your estimate of how your March went?

Secretary GEITHNER. Well, I'd have to check those numbers. But, keep going. Go ahead. I'll be happy to—

Senator KIRK. So, Erskine Bowles, yesterday, testified before the House that we are facing the most predictable economic crisis in history. Would you agree with him?

Secretary GEITHNER. I agree that our long-term fiscal challenges are an imperative for the country to solve, as I said before, in response to Senator Moran's questions. And I agree it's very important we do it. Of course, we have lots of other challenges, too. Our challenge is how to—it's to do that in a way that doesn't hurt the recovery, hurt the economy, hurt our long-term strength and competitiveness.

Senator KIRK. I'll ask the last question. If you were the Chinese, would you lend us another trillion?

Secretary GEITHNER. Of course. Let me just repeat something I said before. The world still views the United States and the American political system as up to the challenge of delivering reforms that make our economy stronger and our fiscal position more sustainable. If you look at what we pay to borrow today, there's still enormous confidence around the world in the capacity of this political system, people in Washington, coming together and solving these problems, because we've always done it in the past. But, we have to earn that confidence every day. And that's why these efforts underway, including the ones that Senator Durbin was part of in the Fiscal Commission, are so important. And it's important, again, that the Congress find a way to come together and lock in comprehensive restraints that reduce those long-term deficits. It's completely within our capacity to do, and we have to make sure we justify that confidence that you see in markets every day now.

Senator KIRK. Thank you, Mr. Chairman.

Senator DURBIN. Thank you, Senator.

WALL STREET REFORM

Mr. Secretary, before joining the administration, you were in New York, at the Federal Reserve, and in the eye of the storm as this recession came upon us. You witnessed, and participated in, discussions that led to an effort to save financial institutions from ruin. And I think, by most standards, the fact that the money has been repaid to our Government—the TARP money—with interest, in most instances, is an indication of recovery among those financial institutions.

The purpose of Wall Street reform was to make certain we never had to walk that road again. We had to make sure that we put in place oversight and regulation so that the excesses which led to our recession were not repeated.

Since passage of that legislation, there has been a steady effort by Wall Street to undo that Wall Street reform. We've seen it in many aspects. I'm not going to raise the issue, but I'm battling an issue over interchange fees, you may have heard of. And clearly, when it comes to the consumer financial responsibility effort, there is an effort to slow down that implementation, or stop it.

As you step back and look at the banking industry, from the darkest days, beginning this recession, until today, I see profit reports which suggest that most are doing quite well. Is there any indication that you can point to of weakness in our financial institutions that has been brought on by too much Government regulation and oversight?

Secretary GEITHNER. Let me say a few things in response to that. I think the U.S. financial system, as a whole, is in a dramatically stronger position today than it was in the years running up to the crisis, not just from the depths of the crisis, but relative to where it was before the crisis. There's much more capital in the banking system, much less leverage. The weakest parts of the system have been washed away by the crisis, appropriately so. And I think what we have left is much stronger.

The challenges we face in the financial system today are—as Senator Moran referred to, is, community banks across the country, who got themselves too exposed to commercial real estate are still facing a lot of challenges. And that’s hurting their small business customers. And, as you know, the housing finance market is still deeply damaged, really at the early stage of—just the beginning of repairing that basic challenge. So, we’ve got a lot of challenge to go.

But, I believe these reforms are absolutely essential to the basic health of the American private sector, are absolutely essential to credibility of the American financial system, globally, when we ask people to invest in the United States, absolutely essential to the ability of this financial system to take the savings of Americans and channel them to people that have an idea and want to build a growing company. And we have to make sure that we meet the basic challenge of the legislation in designing sensible rules. They have to have a balance. You know, they have to preserve competition, some measure of efficiency, a loss of dynamism, innovation. But, we have to do a dramatically better job of protecting the economy, protecting the innocent, protecting investors and consumers from the kind of abuses we felt.

And I think our biggest challenges now are to make sure those reforms get designed well, they’re allowed to take effect, they’re administered by people who have the resources and the independence and the authority to carry out those responsibilities, not subject to political influence. And we’re at the early stage of that process of implementation.

FORECLOSURE CRISIS

Senator DURBIN. Mr. Secretary, yesterday I went to an opening of a housing project in Lawndale, which is on the west side of Chicago. Coincidentally, it was the same location where Dr. Martin Luther King stayed when he lived in Chicago for a short period of time. And they were quite proud of the fact that they have 45 units. The CDFI had a lot to do with it. And as I went to this ribbon cutting, I drove through the neighborhood. And I will tell you that virtually every third home was boarded up with plywood, indicating it was in foreclosure and not currently occupied. It strikes me that this is still an unresolved issue—and you’ve alluded to it—about the value of real estate in America and our housing crisis.

Can we really expect a solid recovery of this economy unless or until we mark-to-market and understand what the true value of real estate is? With so many Americans facing the prospect of being under water in their own personal debt on their homes, are we delaying the inevitable of facing a resolution of this crisis?

Secretary GEITHNER. I don’t think so. It’s important that we not do that. I think you’re absolutely right to remind everybody that the housing market in the United States is still in crisis. It’s not just in California, Florida, Nevada, and Arizona, the states—most affected by the rise in prices and the collapse in prices of construction. But, it’s in cities across the country. And there are still millions more Americans at risk of losing their homes.

There are two really important things that we have to do in the near term to reduce—to address that problem and help repair it.

One is, we have to get the economy stronger. Really the only way, and the most powerful way, to make sure that you bring the market back to a reasonable level, protect the value of people's homes, reduce the risk of foreclosure, is to get more Americans back to work, make sure incomes are growing. Overwhelmingly, that's going to dominate the outcomes.

But, it's also very important that we continue to make sure that we use all the tools we have to make sure that servicers and banks are giving people a chance to stay in their homes if they can afford to do that. Now, the programs we have, have reached millions of Americans, but there's millions more at risk. And we want to make sure we do everything we can to make sure that, again, people who have—who, given a chance, can afford to stay in their home, have that basic chance. Doing those two things are important.

But, again, the most important thing is to make sure everything we do is motivated today by the challenge of getting the economy stronger, more Americans back to work. That's the best thing we can do for those communities still caught up in all the trauma. And it is going to take several more years, under the best of circumstances, to heal that pain, still.

Senator DURBIN. I'm over time, but I'm just going to say, very briefly—2 years ago, I addressed the bankruptcy code as a way to have some reckoning in this process so that banks would know, if they were about to foreclose, or pushed forward foreclosure, leading to bankruptcy, that, ultimately, there would be a bankruptcy judge who would have the power to change the terms of the mortgage and keep the people in their homes. It was fought by the financial institutions. It wasn't enthusiastically supported by the administration. And it failed. And here we are today in a situation where I cannot reconcile, in my mind, how a bank believes that foreclosing on a home, boarding it up, letting the weeds grow in the front yard and the vandals come in and rip out all the copper plumbing until it reaches the point that it becomes a burned out, hollow building and has to be torn down is in the best interest of the banks, let alone the country and the neighborhood. That, to me, is what's happening over and over again. I lived through this in my hometown of East St. Louis, Illinois, and it looks like Dresden, after the bombing, for all the vacant land that's there. And I'm seeing it happen in Chicago. I'm seeing it happen in King County, Illinois. And I see no end in sight.

I know we've tried. I understand what you're saying, "the overall economy is part of it," but I don't believe we have addressed the responsibility of the financial institutions in this situation.

Secretary GEITHNER. I—well, I just want to associate myself with something very important in this context. You've said it for a long time—is that the servicers have done a really terrible job of helping fix and repair and heal and help people through a mess that they helped contribute to. And they are not putting enough resources in this effort. They are not doing a good enough job of helping homeowners navigate through a very complicated, difficult process. They have to do a better job. And, as you know, we're involved in a series of efforts that try to bring more force to a more rapid resolution of those problems.

Senator DURBIN. I would say to you, in closing, Mr. Secretary, on this subject, we have given them a lot of carrots. It's time to find a stick.

Senator Moran.

Senator MORAN. Mr. Chairman, thank you.

BANKING REGULATIONS

Let me follow up on a topic that—a path you started down.

When Senator Durbin describes that neighborhood with the boarded up houses, it brings me back to the value of community banking, in which I—just my commonsense human nature tells me there is a different reaction—if you're the banker who is lending to the house down the street, down the road, you have a lot of care and compassion for your community, and you drive by that house every day; you're going to have a response of trying to figure out, "How do we get this house back in some owner's hands?" And I—again, it gives me the opportunity to reiterate what I said in my opening statement, that—and the reason this—the real estate aspect of this is so prevalent in my mind is, I've had numerous bankers, a half a dozen, tell me that with new regulations, they no longer are making home loans. I think this is a terrible, sad circumstance, in our country, when your hometown banker says, "It's no longer worth the regulatory cost, the fingerprinting of my employees, to make a loan to somebody who lives in our town."

In Kansas and much of Illinois, we have large rural communities—and we have large areas of rural communities in which our bankers know their community very well. And the idea that you can't go to your hometown banker and get a home loan is trouble—is hugely troublesome to me.

Also, a conversation I had with one of our regional bankers, who was telling me, for the first time in their bank's history, instead of the bank—the regional bank calling a community bank, saying, "We're interested in buying your bank," it's now the community bankers who are calling the regional banks, saying, "I can't afford this anymore." The regulatory costs have to spread among such a large group of borrowers—a larger asset base, that we're seeing, in my view, the demise of something that is very important to the life of a community; that's the local financial institution. And while, if that occurs as a result of market forces, that's one thing to me. But, if that occurs because we have an over-regulated lack-of-commonsense regulatory scheme, we ought to be able to fix that problem.

Secretary GEITHNER. I agree with you. And let me just associate myself with your central point. One of the great strengths of this financial system is that we have not just some of the largest, strongest, most innovative global financial companies, but we have 8,000 small community banks that provide a level of diversity, responsiveness, customer service care that is a huge asset for the country. And we want to make sure we do everything we can to sustain it.

And I do not believe that is at risk in any meaningful sense. In fact, the financial reforms that the Congress passed went the extra mile to make sure that institutions that were not part of the problem, did not cause the problem, were not subject to a greater bur-

den from these reforms. They're largely protected from the additional regulations, which are really designed to get at the largest, most risky institutions and risky practices.

Now, what—most of what you're seeing happen in the community banks today is the result of the fact that a number of them—not all of them—got themselves too exposed to commercial real estate and risk. And what you saw—what you've seen is, bank examiners, who got a little bit caught by excess in parts of the country, as they do in every crisis, they're over-correcting now. And the burden you hear banks across the country express concern about is the concern that examiners now are becoming too aggressive and making it harder for them to do things that are economically sensible loans to viable customers. And that's a very important thing to try to counterbalance and resist.

The Chairman of the Federal Reserve, the Chairman of the Federal Deposit Insurance Corporation, our bank supervisors, are aware of this problem and they have been working to try to mitigate it. They're independent of the Treasury. I should say, I can't control what they do in this context. But, I know they're concerned about it, too.

But, I hear what you hear, too, which is, across the country, community banks still say that "We're getting a little bit too much heat from our examiners at a time when we want to increase lending." And we want to make sure we can help counteract that.

Now, the Congress did pass a very well-designed set of programs to help banks—community banks—get access to capital to help support lending and help give more resources to State small business credit programs across the country, which we're doing. And that will help a little bit, too, because not all these banks can go out and raise capital now, even the ones that have viable businesses. And so, we think that's a good, sensible response.

But, I do agree with your concern. And I am, personally, completely committed to make sure that we preserve that great strength of diversity of a banking system that has thousands and thousands of small community banks operating on Main Streets, trying to do a better job and meet the needs of their customers.

Senator MORAN. Well, I'm never quite certain as to whether—how much of the problem is additional regulation, how much of it is additional enforcement or—and, in part, is just the uncertainty of the enforcement: What is coming next?

Secretary GEITHNER. Yes.

Senator MORAN. So, there's a reluctance to lend money. And I have had this conversation with you previously, and with Chairman Bernanke, and with Sheila Bair. We've been down the line. Everybody is sympathetic, and yet the problem continues. And I would say—and I'm not necessarily here advocating for my bankers; I'm here advocating for what I think is important to the economy in putting people to work is banks that can make loans. In communities across our country, across Kansas, access to credit is a determining factor as to whether or not you're going to grow or expand your business. And we have a reluctance on the part of bankers, because of the regulatory burden or uncertainty or enforcement that is making it very difficult for those things to occur.

And I don't know whether you would have somebody at—again, the OTC is firewalled—

Secretary GEITHNER. Yes.

Senator MORAN.—I guess it's part of the Treasury, but not—you don't have direct. But, it would be great to have somebody who would ultimately sit down with community bankers and their customers and say—because I get this, as you would—as I'm doing to you, people do this to me—“Fight bureaucracy. Fight paperwork. Get rid of the unnecessary burden.” It's very hard to fight the word “bureaucracy.” But, if we can have the specific examples of the rules and regulations or the enforcement action that make no sense, we can address those individually, as compared to the big picture of, you know, fighting the bureaucrat.

So, if you have suggestions of who I could get in a room with bankers and their customers, to see if there are the individual items of regulation, or the regulators that are not following the protocols of the exam process, so we can get some certainty back into this process.

Secretary GEITHNER. Happy to work with you on that. And I think you're right to call attention to it. And I would point out that if you look at the broad measures of what businesses report, in terms of credit terms and availability, and if you look at the very broad measures of access to credit to businesses, price of credit, lending terms they face is—it's now starting to improve; not as soon as we'd like, not as quickly as we'd like, but much faster than credit, for example, of consumer—or somebody who wants to borrow to finance a house is improving. And that's encouraging, but we want to reinforce it. And I think we have a long way to go.

Senator MORAN. Mr. Secretary, I have one additional question that I'd like to ask you personally, if you can—if I can catch you, for a few moments, after this hearing.

Secretary GEITHNER. Sure.

Senator MORAN. Thank you.

Senator DURBIN. Senator Lautenberg.

FUNDING TO FIGHT ILLEGAL TOBACCO TRAFFICKING

Senator LAUTENBERG. Mr. Secretary, it's estimated, by the Treasury, that Federal revenue lost due to illegal tobacco trafficking may reach as high as \$4½ billion annually. Now, the Congress provided \$3 million this year for the Alcohol and Tobacco Tax and Trade Bureau to hire agents and improve enforcement efforts. However, the President's budget, next year, would eliminate these positions. Now, without filling these jobs, how will the Treasury have the resources it needs to carry out effective tobacco taxing?

Secretary GEITHNER. Senator, I know this is important to you, and I'm aware of your concern. And I'd like to try to work with you to see if we can address it.

And let me tell you a little bit of what's guiding our judgment. You know, we're finding, across the board, that we're—you know, we're having to do more with less. Where we have limited enforcement resources, we're trying to make sure we devote them to where we have the highest return, in terms of revenues and other objectives the Congress gives us. And so, that's forced us to cut back in some areas. This is an example.

I know why you're concerned about it, because it makes it easier for people to evade these things. That erodes the revenue base of States. And so, I think it's important, in this context. I'd be happy to work with you on this.

We do have a lot of—because of what the Congress enabled us to do the last 2 years—we have a lot enforcement efforts underway which we think have some deterrent value. But, obviously, we want to do as much as we can with the few resources we can. And I'd be happy to work with you on how best we can do that.

Senator LAUTENBERG. So, we need the people to get the job done.

Secretary GEITHNER. We do. Absolutely. And what we did is to—temporarily, is, we used those resources to use IRS agents to help them in a separate, and they're doing a lot of important things—

Senator LAUTENBERG. That imposes an extra burden on those who have the audits to do, and—

Secretary GEITHNER. It does. And, you know, as you've seen, there are some people who want to cut the IRS resources, too. But, again, what we want to do is to make sure that, with the resources you give us, we allocate them to where they have the highest possible return. And I know why this is important to you.

INFRASTRUCTURE BANK PROPOSAL

Senator LAUTENBERG. Yes. The administration has recommended an infrastructure bank to fund transportation projects of national significance. Now, at a time when budgets are stretched so thin, how would the administration's proposal focus Federal dollars to maximize our country's economic competitiveness?

Secretary GEITHNER. Well, as you know, we face a huge long-term infrastructure deficit that puts enormous burden—it hurts the competitiveness of American businesses by raising the cost of doing business, bringing their products to market. And so, as you think about the long-term challenge we face, we have to find a way to finance, responsibly, much higher levels of infrastructure across the country.

We believe an infrastructure bank or fund is—should be part of the solution. It can't be the entire solution. And what it does is give us the chance to get better use of limited taxpayer resources to borrow from the market and bring private capital alongside what the Government does directly so get—we get more power, more bang, more ammunition behind these financing projects.

And there's a lot of interest in this in the Congress, as I know how—you've been a big supporter of this. There are some new ideas in the Congress, too. And we'd like to work with you and your colleagues to figure out how we get something done.

Again, one of the most important things we can do to help get more Americans back to work, to help increase employment opportunities for people most affected by the crisis, in construction, for example, and for our long-term competitiveness, is to invest substantially more in infrastructure projects that have a high return over time. And we cannot do that adequately through the traditional mechanisms the Congress has used to fund, for example, transportation budgets.

Senator LAUTENBERG. Will we hear some of what might be considered, in the near future, so that we can get on with this?

Secretary GEITHNER. Yes. We're—again, we've—have a series of detailed proposals we've been modifying as a way to get more support in the Congress. And there's a bunch of new ideas on the Hill that we want to work with you on. And again, I think this is something that we should be able to do. It's not a partisan issue. It's traditionally had a lot of bipartisan support. And it's a good, efficient use of taxpayer resources.

CORPORATE TAX HOLIDAY

Senator LAUTENBERG. Well, some companies are pushing for a tax holiday if they repatriate income that's currently invested overseas. These companies believe that it's going to—that it will boost the U.S. economy, create jobs. I'm skeptical about it, but some have suggested that a tax holiday may make sense in the larger context of corporate tax reform. How do you feel about that kind of proposal?

Secretary GEITHNER. That's something we would not consider outside the context of corporate tax reform, because—for the reasons you said, on the basis of how it's been—of the experience in the past. It's a—well, I won't say—I'll say it directly—it has not produced an increase in investment, job creation. And it's expensive. So, we would not support it outside the context of corporate tax reform. But, in the context of comprehensive corporate tax reform, we think there may be a way to try and do that in a way that would be responsive to these broader interests of trying to get more of those resources held overseas, to bring them back. But, not outside of that context—

Senator LAUTENBERG. No, because it's believed that, by keeping these companies from bringing back the income that they've earned, that we're not only losing revenues, but we're also increasing competition within—for jobs within our own country.

Secretary GEITHNER. That's right. That's why it's a very good idea to try to do comprehensive reform that lowers the statutory rate, broadens the base, and again, improves the incentives for people to bring back those resources and invest more in the United States. And that's what our reforms—we're going to try and do. And you'll see, in that proposal, that we're going to try to find a way to be responsive to that broader interest. Again, what we want to do is improve incentives for people investing more of those resources here in the United States.

FUNDING FOR THE CFPB

Senator LAUTENBERG. Our colleagues on the other side of the aisle have proposed to cut the new CFPB's budget this year to \$80 million. The CFPB estimates that we'll need approximately \$143 million to do its job. If the House Republicans get their way, how is that going to affect the CFPB's ability to start up and fulfill its mission of protecting consumers?

Secretary GEITHNER. Well, again, the purpose of those cuts are to starve this entity of the resources it needs to get going. And what that will do is put at risk—I gave one example to Senator Moran, but I'll repeat that and tell you another one. What the—the most important priorities of this bureau from day one are to simplify and improve disclosure for people who want to get a loan

to buy a house or to borrow against their credit card. And providing more simple disclosure, so people understand how to borrow responsibly, can shop for a better deal, is an overwhelmingly sensible simple objective. You will delay—make it harder for the agency to do that. The other thing that would make it harder to do, if you starve it of resources, is—as I said to Senator Moran, is, you’ll leave banks with an unlevel playing field, where they’re competing against nonbank finance companies, without constraint, who might be trying to take advantage of their customers in that context. That’s not good for banks or for consumers. Those are two examples of what you put at risk.

Senator LAUTENBERG. Thanks, Mr. Secretary.
Thanks, Mr. Chairman.

FINANCIAL CRIMES ENFORCEMENT NETWORK

Senator DURBIN. Mr. Secretary, in my opening statement, I mentioned the Financial Crimes Enforcement Network, which—I don’t know if many people follow it, but FinCEN, as it’s known, collects red flags on suspicious financial transactions from banks and other financial entities. Hundreds of Federal, State, and other local law enforcement agencies access this data to track the financial paper trail of criminal financial activity, including terrorist financing, organized crime, and drug trafficking.

In many places, like Chicago and New York City, local law enforcement entities have direct access to this data. In fact, in Illinois, 75 users ran more than 20,000 searches on the FinCEN database in 2010.

Under the Treasury proposal for next year’s budget, all those searches would have to funnel through just two staffers at the State level. The Treasury would save \$1.3 million with the proposed cuts in this agency. It seems to me that FinCEN has a significant role in dealing with the use of our financial network by wrongdoers: criminals, drug traffickers, would-be terrorists. This proposed cut seems to me to be penny-wise and pound foolish. Can you comment?

Secretary GEITHNER. Yes, Mr. Chairman. Thank you for raising this. And I understand your concerns. And we will work with you to try to mitigate that effect.

And you’re right, and I appreciate very much what you said in your opening statement, about the important role FinCEN provides, as a whole. And, of course, we’re always looking for ways to make sure that we’re directing them to things that can have the maximum positive impact in reducing the ability of people to take advantage of our financial system, in this case. And this is one example.

Now, you’re concerned about the effect this would have on local law enforcement officials, particularly in the really major cities’ largest law enforcement operations in the country; and I am optimistic we can find a way to try to address those concerns. Of course, in our proposal, we’re preserving direct access for them to the resources of FinCEN. But, I understand your concerns, and I think we can work with you to try to mitigate those.

Senator DURBIN. Senator Moran.
Senator MORAN. Mr. Chairman, thank you.

IRAN SANCTIONS

I'm not exactly sure—Mr. Kirk—I think his conversation with you is—was about the World Bank. I did want to make certain that you understand the importance of enforcement—strict and strong enforcement—of the Comprehensive Iran Sanctions and Accountability Act that the Congress passed several years ago. And I assume that you would tell us that you're taking your job very seriously.

Secretary GEITHNER. Absolutely. We are taking it very seriously. And again, we had a very powerful program. The law the Congress passed gave us much more power. And it's had a dramatic impact on our capacity to make sure that other countries around the world joined us in tightening the constraints on the Government of Iran.

But, as Senator Kirk reminded us, and as I said, this is an ongoing challenge, and it requires a relentless focus to try to make sure you catch every opportunity for evasion, and stay on it. And again, we've got some incredibly talented people with a great record in this area. And we work every day to try to make sure we can do a better job. And the Congress gave us much more powerful tools.

Senator MORAN. There's no additional—there's no need for additional—authority, statutory authority, or—you have the tools that you need?

Secretary GEITHNER. I don't think so. I think our big challenge, as you know, is to try to get other countries to come with us. You know, we don't do material business, really, now, and—but much of the rest of the world does. And so, what we've been successful doing with these new powers is to tighten the net by getting other countries to come with us. But, you know, we've got some more work to do not that front.

ADDITIONAL COMMITTEE QUESTIONS

Senator LAUTENBERG. Mr. Chairman, thank you.

Mr. Secretary, thank you for your consideration.

[The following questions were not asked at the hearing, but were submitted to the Department for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

Question. The Appropriations Subcommittee on Financial Services and General Government maintains jurisdiction over the annual appropriations for the Office of Foreign Assets Control (OFAC), a Department of the Treasury office dedicated to administering and enforcing economic and trade sanctions. On February 25, 2011, President Obama signed an Executive order freezing Libyan assets in United States banks, significantly limiting Muammar Gaddafi's ability to access funds to support attacks on his own people. The Washington Post reported that OFAC quickly identified \$32 billion in Libyan assets and that United States banks began freezing funds within minutes of the Executive order going into place.

What authority does Treasury have to freeze foreign assets when there is a threat of a humanitarian and/or national security crisis? How is this decision made?

Answer. In issuing an Executive order imposing economic sanctions, the President generally invokes the authority of the International Emergency Economic Powers Act, and declares a national emergency to deal with a particular threat to the national security, foreign policy, or economy of the United States. Treasury's OFAC then acts under delegated Presidential national emergency powers to implement provisions of the Executive order, which can include blocking targeted assets under U.S. jurisdiction.

Question. How is OFAC ensuring that U.S. financial institutions are complying with the directive to freeze Gaddafi's assets? What are the consequences of non-compliance?

Answer. OFAC uses a variety of tools to ensure compliance by U.S. financial institutions. In the case of a new sanctions program, OFAC immediately posts notice of the sanctions' legal requirements via several electronic means to the United States and international financial community. By law, holders of blocked assets must report to Treasury within 10 days after blocking assets, although they typically will report major blockings within 2 to 4 days. OFAC has the authority to impose civil penalties if appropriate. OFAC also works very closely with Federal and State financial regulators, which require financial institutions to maintain adequate programs to ensure compliance with OFAC regulations. OFAC is actively engaged with U.S. financial institutions to address implementation issues and it may issue subpoenas to obtain information when there is an indication that a financial institution has failed to act properly.

Question. What happens to these funds after they are frozen? Will they be made available to the Libyan people when the political situation is stabilized in that country?

Answer. In taking action to block Libyan Government assets under the President's Executive order, the United States has protected those assets from misappropriation by the Gaddafi regime, and is depriving the regime of the use of those assets for its ongoing campaign of violence against the Libyan people. On July 15, 2011, the United States recognized the Transitional National Council (TNC) as the legitimate governing authority for Libya. To assist the TNC and the Libyan people during this time of transition, we are working with the State Department to make a portion of the frozen assets available to the TNC as soon as possible. We are keenly focused on the humanitarian and other essential needs of the Libyan people, and we are working closely with our international partners to address those needs. To that end, on August 25, the United Nations Security Council's Libya Sanctions Committee agreed to a United States "extraordinary expenses" request facilitating the issuance of United States licenses to authorize the release of up to \$1.5 billion in Libyan assets for humanitarian and other essential needs. Consistent with TNC instructions and State Department guidance, we have authorized the release of funds for humanitarian and other urgent needs. These efforts are being negotiated carefully to provide for adequate oversight and transparency in how the funds will be used. Going forward, we will continue to work closely with the State Department, the TNC and our international partners to determine an appropriate plan for releasing assets in light of the situation on the ground as it evolves. While we seek to provide the TNC with the resources necessary to address humanitarian and other essential needs, we also will work with the State Department, the TNC and our international partners to continue safeguarding these assets for the Libyan people in a manner consistent with our United Nations obligations.

Question. The Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (Public Law 111-195) tightened economic sanctions on Iran in response to its nuclear weapons program, focusing in particular on Iran's petroleum industry. The administration has also taken steps through the Treasury Department and the United Nations Security Council to tighten sanctions even further against Iran.

In 2010, The New York Times reported that over the last decade, the Federal Government awarded more than \$107 billion in contract payments, grants, and other benefits to foreign and multinational American companies while they were doing business in Iran—including nearly \$15 billion paid to companies that defied United States sanctions law by making large investments that helped Iran develop its oil and gas reserves.

What steps has Treasury taken to enforce these sanctions, especially with regard to recipients of Federal funds? What further steps does Treasury plan to take?

Answer. Treasury's Office of Terrorism and Financial Intelligence has been engaged in an aggressive campaign to implement the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (CISADA), reaching out to countries around the world through travel and correspondence.

Treasury's outreach on CISADA has had a tremendous effect, and the great majority of financial institutions with which we have engaged have chosen to close their correspondent accounts with United States-designated, Iranian-linked financial institutions, thus shutting down avenues that Iran's designated banks had relied upon to engage in financial activities.

Treasury aggressively implements and enforces sanctions against entities and individuals subject to such sanctions. Since the adoption of United Nations Security Council Resolution 1929 in June 2010, Treasury has designated dozens of Iranian entities and individuals for involvement in Iran's proliferation-related activities or

for being responsible for human rights abuses in Iran. Actions taken pursuant to Executive Order 13382, which targets WMD proliferation networks and their supporters, have included designations of affiliates of the Islamic Revolutionary Guard Corps and the Islamic Republic of Iran Shipping Lines; Tidewater, an Iranian port operator; entities subordinate to Iran's Aerospace Industries Organization; and additional Iranian-linked financial institutions, including Europaisch-Iranische Handelsbank, Post Bank of Iran, Bank Refah, and the Bank of Industry and Mine, bringing the total number of designated Iranian-linked financial institutions to 21. Treasury also continues to work with international partners to implement robust international sanctions on Iran so that Iran feels pressure not only from U.S. actions but also from increasing isolation from the international financial system.

On September 28, 2010, the President signed Executive Order 13553, authorizing the freezing of assets of officials of the Government of Iran or persons acting on behalf of the Government of Iran who are responsible for or complicit in, or responsible for ordering, controlling, or otherwise directing, the commission of serious human rights abuses against persons in Iran or Iranian citizens or residents, among others. The Annex to Executive Order 13553 listed eight Government of Iran officials for their involvement in human rights abuses. Treasury has since designated additional Government of Iran officials for their involvement in serious human rights abuses.

The State Department enforces the energy-related provisions of the Iran Sanctions Act, as amended by CISADA, and as a result, I must defer to the State Department on questions regarding the energy-related sanctions.

Question. Over the last decade, the Treasury Department has granted nearly 10,000 licenses for commerce involving countries listed as state sponsors of terrorism—using loopholes for humanitarian and agricultural aid to sell items such as cigarettes, chewing gum, hot sauces, weight loss remedies, and even sports rehabilitation equipment for the institute that trains Iran's Olympic athletes.

What steps has Treasury taken to ensure that only agricultural and humanitarian goods are waived into countries such as Iran? What more can be done?

Answer. Under the Trade Sanctions Reform and Export Enhancement Act of 2000 (TSRA), Congress requires Treasury to grant licenses to U.S. companies seeking to export agricultural commodities, medicines, and medical devices to certain sanctioned countries. By the terms of the statute, OFAC is limited in its ability to deny licenses for goods that fall within the categories as defined in the statute. For example, TSRA takes its definition of "agricultural commodities" from section 102 of the Agricultural Trade Act of 1978 (7 U.S.C. 5602). In interpreting the definition of "agricultural commodities," Treasury looks to the Department of Agriculture, which is better equipped to determine what qualifies under the definition. Similarly, TSRA relies on section 201 of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 321) to define medicine and medical devices. Circumstances for denying TSRA licenses include when the importing entity "promote[s] international terrorism" or when it is unlawful to export to an entity that is subject to any restriction for its involvement in weapons of mass destruction or missile proliferation.

Question. When United States companies attempt to do business in Africa, they are often at a disadvantage due to competition from foreign governments who operate outside of the Organisation for Economic Co-operation and Development arrangement, notably the Chinese. Often African buyers prefer the quality of American products but are attracted to the inexpensive, flexible concessional financing offered by the Chinese and others. United States companies complain that United States Government tools to level the playing field in the face of these Chinese tactics, including Export-Import Bank's War Chest, are too restrictive.

What steps has Treasury taken to level the playing field in overseas markets for United States companies facing Chinese concessional financing and other tactics?

Answer. China's accession to the international arrangement that disciplines the provision of official export credits, thereby subjecting China's export credit and tied aid activity to clear financing and transparency rules, is a top priority for the administration. Senior Treasury offices and I have raised this issue with our Chinese counterparts, and, at the recent May Strategic and Economic Dialogue meetings, the United States and China "recognize[d] the importance of transparency and fairness in providing export credits" and "agree[d] to exchange views on the importance of the export credit system." We will continue to engage the Chinese on this important issue.

The Ex-Im Bank War Chest is available to match tied aid that violates the international rules or that is a threat to long-run U.S. market share/access in emerging markets. Separate from the War Chest, Ex-Im also has the legal authority to match Chinese export credits, whether or not they are consistent with the international rules. This authority was recently used in a Pakistan rail transaction, where Ex-

Im provided matching financing to a United States company competing against a Chinese company with Chinese Government financing that did not conform to international standards and practices.

Question. The Treasury Department is 1 of 20 U.S. Government agencies represented on the Trade Promotion Coordinating Committee. What is the Treasury Department currently doing to coordinate and boost American export promotion and financing operations?

Answer. In addition to Treasury's general efforts to support the administration's work to increase exports, Treasury is responsible for promoting balanced and strong growth in the global economy through the G-20 Financial Ministers' process and other appropriate mechanisms.

Treasury has advocated for a rebalancing of global demand, which is an essential part of achieving a strong and long-lasting global economic recovery. Faster domestic demand growth abroad, particularly by countries with trade surpluses, will enable countries with trade deficits to boost their exports, and narrow or eliminate their current account deficits. A more evenly balanced global economy will contribute to a more sustainable global recovery.

Question. In addition to Treasury's role, which executive agency should and which, if any, is leading the interagency process on this effort?

Answer. The President's National Export Initiative is being coordinated by the Commerce Department under the umbrella of the Trade Promotion Coordinating Committee.

DOMESTIC FINANCE

Question. In January 2011, news reports raised concerns about several banks that were found to have taken advantage of servicemembers by overcharging for mortgages and improperly starting foreclosure proceedings. These banks violated the Servicemembers Civil Relief Act (SCRA) and added financial stress to the already stressful lives of military families. JP Morgan Chase alone sent refunds to 4,000 servicemembers who were overcharged for mortgages or against whom the company improperly started foreclosure proceedings. JP Morgan Chase admitted that it overcharged military personnel on their mortgages and wrongfully foreclosed on 14 active-duty families, despite SCRA and its prohibition on foreclosures against servicemembers.

What can the Treasury Department do to prevent violations of SCRA from happening in the future, including wrongful foreclosures and violations of the mortgage interest cap?

How can Treasury promote proper training on Servicemembers Civil Relief Act (SCRA)?

Answer. The Office of Servicemember Affairs (OSA), located within the Consumer Financial Protection Bureau (CFPB), will play an important role in educating servicemembers on the protections afforded by the , as well as ensuring that any SCRA-related complaints filed with the CFPB are handled in an efficient and timely manner. Although the Department of Justice (DOJ) and the prudential regulators enforce the statute, the CFPB will help raise awareness of the law and its protections, both within the military community and within the financial community. To that end, the OSA recently signed a joint Statement of Principles with the Judge Advocate Generals of the Army, Navy, Air Force, Marine Corps and Coast Guard, and will work with them and the DOJ on this mission. After alleged violations of the SCRA came to light earlier this year, Holly Petraeus, Assistant Director for the OSA, wrote a letter to the CEOs of the Nation's 25 largest banks, asking them to review their policies and procedures to ensure that they were complying with the SCRA. Assistant Director Petraeus has also been engaging the military community across the country to raise awareness of the unique financial protections available to military families, including those afforded by the SCRA.

QUESTIONS SUBMITTED BY SENATOR BEN NELSON

DOMESTIC FINANCE

Question. I continue to hear from both banks and home builders in Nebraska that examiners are turning regulatory guidance on commercial real estate (CRE) lending into hard caps.

For example, it's my understanding that community banks are being told they can't give home builders loans because the bank has reached its 100 percent of capital threshold on construction loans. This cap is being enforced in areas of high housing demand. Builders still can't get a loan. Is it true that regulators are not

allowing these loans to be made to creditworthy builder borrowers with viable projects because a bank has reached the 100 percent of capital CRE threshold?

Answer. Treasury does not regulate community banks. However, Treasury does have a policy interest in ensuring that banks continue to provide credit to small businesses, including home builders, consistent with safety and soundness, in order to support economic recovery and market stability.

Policy guidance issued jointly by Federal banking regulatory agencies in 2006¹ set supervisory criteria for significant CRE concentration:

- total reported loans for construction, land development, and other land (often called for acquisition, construction, and development [ACD]) represent 100 percent or more of the institution's total capital; or
- total commercial real estate loans as defined in the Guidance represent 300 percent or more of the institution's total capital and the outstanding balance of the institution's CRE loan portfolio has increased 50 percent or more during the prior 36 months.

These criteria are explicitly intended neither as limits nor safe harbors, but rather as preliminary steps to identify institutions that may have CDE concentration risks, and this policy remains in effect. The policy states that the effectiveness of an institution's risk management practices will be a key component of the supervisory evaluation of the institution's CRE concentrations. Examiners will engage in a dialogue with the institution's management to assess CRE exposure levels and risk management practices. Institutions that have experienced recent, significant growth in CRE lending will receive closer supervisory review than those that have demonstrated a successful track record of managing the risks in CRE concentrations.

In recent years many banks did exceed these concentration criteria and encountered financial difficulties. Some of these banks are no longer in business. Troubled banks are subject to stringent regulatory restrictions based on each bank's circumstances. It is our understanding that very few banks are currently above, at or near the 100 percent ACD benchmark.

While it is regulatory policy to encourage prudent lending, including to small home builders, such credit may be more challenging to obtain now than previously. Among other factors, some lenders have tightened their own credit standards, some builders have less financial strength, lower property values provide less collateral, and housing market conditions remain weak or fragile in many areas.

Question. I continue to hear from home builders in Nebraska that they are unable to obtain financing to build homes for qualified home buyers. These builders are typically small businesses building 25 or fewer homes a year that rely primarily on commercial banks and thrifts as their primary source of construction loan financing.

A common complaint I hear from such builders is that overly restrictive actions by Federal banking regulators and examiners go well beyond the steps needed to ensure safety and soundness. Have your institutions noted any specific regulatory obstacles to your ability to lend to small businesses including home builders?

Answer. Treasury does not regulate community banks. However, Treasury does have a policy interest in ensuring that banks continue to provide credit to small businesses, including home builders, consistent with safety and soundness, in order to support economic recovery and market stability.

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¹ See, e.g., FDIC FIL-104-2006, Commercial Real Estate Lending (Joint Guidance), December 12, 2006.

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Question. It is my understanding that through economic sanctions the United States has been able to freeze nearly \$33 billion in Libyan assets. I understand that other nations have been able to freeze Libyan assets as well.

How will the United States and NATO dispense with these frozen assets?

Answer. As of June 15, approximately \$37 billion of cash and securities under U.S. jurisdiction have been blocked pursuant to Executive Order 13566. This amount includes assets of the Central Bank of Libya and the Libyan Investment Authority, among others. In taking action against Libyan Government assets under the President's Executive order, the United States has protected those assets from misappropriation by Colonel Muammar Gaddafi and his associates and deprived the Gaddafi regime of the use of those assets for its ongoing campaign of violence against the Libyan people. On July 15, 2011, the United States recognized the Transitional National Council (TNC) as the legitimate governing authority for Libya. To assist the TNC and the Libyan people during this time of transition, we are working with the State Department to make a portion of the frozen assets available to the TNC as soon as possible. We are keenly focused on the humanitarian and other essential needs of the Libyan people, and we are working closely with our international partners to address those needs. To that end, on August 25, the United Nations Security Council's Libya Sanctions Committee agreed to a United States "extraordinary expenses" request facilitating the issuance of United States licenses to authorize the release of up to \$1.5 billion in Libyan assets for humanitarian and other essential needs. Consistent with TNC instructions and State Department guidance, we have authorized the release of funds for humanitarian and other urgent needs. These efforts are being negotiated carefully to provide for adequate oversight and transparency in how the funds will be used. Going forward, we will continue to work closely with the State Department, the TNC and our international partners to determine an appropriate plan for releasing assets in light of the situation on the ground as it evolves. While we seek to provide the TNC with the resources necessary to address humanitarian and other essential needs, we also will work with the State Department, the TNC and our international partners to continue safeguarding these assets for the Libyan people in a manner consistent with our United Nations obligations.

Question. Is there a precedent for how to dispense with such assets?

Will Treasury coordinate with the Department of State in this process?

Is there any consideration to use these funds to either offset military operations in Libya or to help rebuild Libya in the aftermath of the current conflict?

Answer. While we do not have a precedent for making funds available on this scale, consistent with TNC instructions and State Department guidance, we have authorized the release of funds for humanitarian and other urgent needs. Treasury is coordinating with the State Department regarding U.S. efforts to make a portion of the frozen assets blocked pursuant to Executive Order 13566 available to the TNC as soon as possible. The funds are not being considered as a means to offset military operations, but would be used to address humanitarian and other essential needs, as well as support the Libyan people as they chart a democratic, prosperous, and secure future for their country.

Question. To date, what has been discussed and what is possible regarding the use of these funds?

Does Treasury anticipate needing any new authorities to handle these assets?

If new authorities aren't required, what existing authorities will be used to dispense with these funds?

Is there anything that Congress can do to facilitate proper disposal of these assets?

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QUESTIONS SUBMITTED BY SENATOR JERRY MORAN

Question. There is an aerospace industry issue which has come to my attention that I'd like to get your thoughts on. It is in reference to trade finance and our ability to provide defensive competitive matching in instances of Government financing from the official export credit agencies of other countries. I understand that this is a looming issue for aircraft manufacturers and I further understand that the administration has at its disposal an existing provision in U.S. law (section 1912 of the Export-Import Bank Act Amendments of 1978) that could be used to address this competitive situation. It appears to me that the Congress instituted a competitive matching tool for these exact circumstances—one of its supporters, Senator Adlai Stevenson, stated very clearly on the Senate floor during debate: "The [Section's] purpose . . . is not to declare or to accelerate a credit war. Its purpose is to put the United States in a position to end a credit war." And, on the House side, Representative Hannaford declared: "These circumstances demand an appropriate response from our own government. The Export-Import Bank can and should be the instrument of our response."

Does the administration have any intentions to deploy this tool in the fight against such lending practices in support of the aerospace industry and its hundreds of thousands of workers, as well as for all U.S. industries who are or will be facing similar competitions in the near-future.

Answer. Section 1912 is a provision that allows Treasury to authorize Ex-Im Bank to provide matching financing when it determines that foreign noncompetitive official export credits are being offered into the United States that are inconsistent with certain standstills, arrangements or practices. Upon receipt of information that foreign noncompetitive official exports are being offered, Treasury would initiate an inquiry as to whether the statutory criteria under section 1912—which would be fact specific and depend on the scope of an individual case—have been met.

DOMESTIC FINANCE

Question. Recognizing the distinct differences between large banking institutions and insurance companies with small bank subsidiaries, Congress included language in the Dodd-Frank Act stating the Volcker Rule should "appropriately accommodate the business of insurance." Is it your understanding that these provisions allow for insurance companies to continue to sponsor and invest in private equity pursuant to this insurance exception? Do you anticipate any further clarification of this question in any proposed rule?

Answer. The Volcker Rule includes specific provisions to accommodate the business of insurance. Only two types of insurance companies are subject to the Volcker Rule:

- insurance companies that are affiliates of insured banks or thrifts; and
- non-bank financial companies supervised by the Federal Reserve Board.

Under the Volcker Rule, activity for the general account is permitted if the activity is already in compliance with State insurance investment law, regulation, and

guidance; and the appropriate Federal banking agencies, after consultation with the Financial Stability Oversight Council and the relevant State insurance commissioners, have not jointly determined that such investment laws, regulations, and written guidance are insufficient to protect the safety and soundness of the banking entity, or of the financial stability of the United States. These permitted activities are subject to a prudential “backstop” that prohibits such activity if it would result in a material conflict of interest, material exposure to high-risk assets or high-risk trading strategies, a threat to the safety and soundness of the banking entity, or a threat to the financial stability of the United States.

The rulemaking agencies are currently drafting the regulations that will implement the Volcker Rule and it is likely that a forthcoming Notice of Proposed Rulemaking will further clarify this accommodation of the business of insurance.

Question. As you are aware, the Dodd-Frank Act allows for an insurance expert to serve on the Financial Stability Oversight Council (FSOC). When do you think the President will have a nominee for that position, and do you expect that the nomination will be submitted before any regulations that may affect the insurance industry are voted on by the FSOC?

Answer. The FSOC is progressing in a prudent and informed way in its decision-making, and is relying on the considerable expertise already extant among its members to ensure that it benefits from a wide variety of views.

On June 27, 2011, the President nominated Mr. Roy Woodall as the independent member of the FSOC. Mr. Woodall brings extensive experience and insurance expertise to the FSOC. He served as the Senior Insurance Policy Analyst at the Department of the Treasury from 2002 to 2011, and has served as President of the National Association of Life Companies and former Commissioner of Insurance for the Commonwealth of Kentucky over the span of his distinguished career.

The FSOC also benefits from the service of Mr. John Huff, the Director of the Missouri Department of Insurance, Financial Institutions and Professional Registration, who was selected as a member by the State insurance commissioners. Mr. Huff offers a breadth of knowledge and the important perspective of the primary functional insurance regulators.

Secretary Geithner has appointed Mr. Michael McRaith as the director of the Federal Insurance Office (FIO). Mr. McRaith, who joined the FIO as director in June 2011, was previously the director of the Illinois Department of Insurance. He brings significant experience and judgment to the FIO and as a member of the FSOC.

CONSUMER FINANCIAL PROTECTION BUREAU (CFPB)

Question. Can you please describe for me how the CFPB’s budget will be audited upon its standing up in July of this year? Who will perform the audits and how will the results of the audits be made public?

Answer. The CFPB is required to have two independent audits in 2011. The first is an audit of the financial transactions of the Bureau, which is being performed by the Comptroller General of the United States. Under the Dodd-Frank Act, the Comptroller General shall submit to the Congress a report of this audit, which is typically made available to the public on the Web site of the Government Accountability Office. The CFPB is also required to order an annual independent audit of the CFPB’s operations and budget under section 1016A of the Department of Defense and Full-Year Continuing Appropriation Act of 2011. The CFPB will publish its audited financial statements and the annual independent audit on its Web site.

QUESTIONS SUBMITTED BY SENATOR MARK KIRK

DOMESTIC FINANCE

Question. In a recent conversation with Chicago’s City Treasurer, she reminded me that a downgrade in U.S. debt would not only effect borrowing by the Federal Government, but would cascade down to the States. Keeping last week’s downgrade of Spain’s and Greece’s debt in mind, I believe that the Federal Government’s fiscal discipline initiatives will both help States control their interest costs and prove that the United States continues to be a model for the rest of the world. How can the United States demonstrate national and global leadership for spending reforms and debt reduction?

Answer. Addressing the challenges we face in the short term to revive our economy and in the long-term economic path to growth requires fiscal responsibility. We need to reduce annual deficits, now roughly 10 percent of GDP, to the point where the overall debt burden begins to fall as a share of the economy. This must be a

multi-year process, with cuts phased in over time, so as not to risk our economy as it emerges from the recession.

Our objective is to build a bipartisan consensus on a comprehensive, and balanced fiscal reform plan. We must reduce Government spending while financing productive investments in areas critical to future economic growth, along with generating more revenue and reducing the rate of growth in spending on health care and retirement security.

We must take a balanced approach that includes shared sacrifice in order for our Government to live within its means. I remain optimistic that we can address our fiscal challenges in a bipartisan manner that sets an example for the world, renews investor confidence, and demonstrates to the American people that we can work together to improve the well-being of our economy and our country.

Question. On January 21, the Treasury's official blog wrote that, "Adopting a policy that payments to investors should take precedence over other U.S. legal obligations would merely be default by another name, since the world would recognize it as a failure by the U.S. to stand behind its commitments." If a State fails to make timely payments of obligations, for example, if it delays payment of Federal education funds to local schools, would the State be considered in default under your definition? If failure to stand behind commitments would constitute a default for a State government, what responsibility would Treasury have to stand behind a State's legal obligations?

Answer. Where a State has a legal obligation to make payments at a specified time, nonpayment would be recognized by investors and others as a failure by that State to meet its commitments. The resulting damage to that State's creditworthiness would likely be severe. However, Treasury does not have a general responsibility to stand behind a State's legal obligations.

Question. I would like to ask you about a State that has been becoming more of a rogue player on the international stage—Argentina. At least one member of the House has asked for review of Argentina's GSP status. There have been reports that Argentina has discussed overlooking Iranian ties to terrorists' attacks on Argentina's soil in order to get some economic concessions. All of this is going on while the Republic of Argentina has been negotiating with the Paris Club to repay the \$9 billion in debt that resulted from Argentina's 2001 sovereign debt default. Of this \$9 billion, about \$360 million is owed to the United States. Private U.S. creditors are still owed \$3.5 billion—nearly 10 times as much as the debt the U.S. Government is seeking to recover. Currently, Argentina holds more than \$54 billion in foreign reserves. What is Treasury's office of International Affairs doing to recover these funds, which Argentina is clearly able to pay? What is the message that we send to Argentina and other States by allowing it to get away with incendiary economic behavior?

Answer. I can assure you that the Treasury Department is carefully monitoring several problem areas associated with Argentina's conduct toward United States investors and unfulfilled obligations to international agreements and institutions. We are pressing the Government of Argentina to uphold its international commitments as a member of the G-20, International Centre for Settlement of Investment Disputes, International Monetary Fund (IMF), and other multilateral fora, and normalize relations with its creditors. Specifically, with regard to the Paris Club, the Treasury Department has sought and will continue to seek full repayment from Argentina on behalf of U.S. taxpayers.

Question. The President's budget claims Treasury's funding "Enables the implementation of critical reforms to the U.S. financial regulatory system through support for the Dodd-Frank Wall Street Reform." What safeguards and oversight exist to ensure that this funding is used effectively and that the new programs implemented under Dodd-Frank are being used effectively and efficiently? I am advocating a set of principles based on quantitative metrics to use in evaluating appropriations bills that can measure Dodd-Frank's effectiveness:

- Programs must be subject to rigorous performance evaluation requirements and oversight/enforcement that includes quantitative metrics and goals;
- New regulatory measures must not duplicate existing ones; and
- Programs that cannot minimize fraud and abuse should not be considered for expanded funding.

Answer. On January 18, 2011, President Obama issued Executive Order 13563, "Improving Regulation and Regulatory Review," directing executive agencies to streamline and simplify regulations, seeking to ensure cost-effective, evidence-based regulations that are compatible with economic growth, innovation, job creation, and competitiveness.

On July 11, 2011, he also issued Executive Order 13579, "Regulation and Independent Regulatory Agencies," which calls upon independent agencies, to the extent

permitted by law, to comply with provisions of Executive Order 13563. This includes the Executive Order 13563 provision that asks agencies to develop a plan under which the agency will periodically review its existing significant regulations to determine whether any such regulations should be modified, streamlined, expanded, or repealed so as to make the agency's regulatory program more effective or less burdensome in achieving the regulatory objectives. The implementation of Dodd-Frank provides financial regulators with both an opportunity and a responsibility to implement the most efficient and effective rules for the financial system, to avoid duplicative or conflicting rules, and to eliminate those that are outdated.

Question. What is the status of Treasury investigations into additional violations of the Iran Sanctions Act of 1996 (ISA) and the 2010 Comprehensive Iran Sanctions, Accountability, and Divestment Act (CISADA)? How many companies and/or banks is the Treasury Department currently investigating for violations of the ISA and CISADA? Can you provide a timeframe of when additional designations are to be expected?

Answer. As a matter of longstanding policy, Treasury does not comment on any possible or pending investigations, including possible sanctions. Accordingly, it would not be appropriate for me to comment on any particular financial institutions that may be under investigation until a final determination has been made regarding sanctions.

Since the enactment of CISADA on July 1, 2010, and the publication of the Iranian Financial Sanctions Regulations on August 16, 2010, Treasury has been engaged in an aggressive campaign, involving dozens of foreign countries and scores of financial institutions, to explain the choice put to foreign financial institutions by CISADA between continued direct access to the United States financial system or continued involvement with Iran's proliferation efforts, its support for terrorism, and sanctioned Iranian-linked parties such as United States-designated banks and the Islamic Revolutionary Guard Corps. The response to Treasury's outreach has had a tremendous effect, and the great majority of financial institutions with which we have engaged have chosen to close their correspondent accounts with United States-designated, Iranian-linked financial institutions, thus closing off avenues that Iran's designated banks had relied upon to engage in financial activities. CISADA, in short, has proven to be a very powerful tool to further isolate and pressure Iran. Nonetheless, Treasury has concerns that a limited number of foreign financial institutions may be continuing to engage in activities that could result in a finding under CISADA. We are actively investigating those situations.

The State Department is responsible for implementing the Iran Sanctions Act and the energy-related provisions of CISADA, and as a result, I must defer to the State Department questions regarding the energy-related sanctions.

Question. Given that Spain appears like the next domino to fall in the European sovereign debt crisis, are you concerned that additional United States taxpayer funds may be required to support the IMF? Since the Congressional Research Service (CRS) estimates that Spain may need more than \$500 billion for international bailout, do you anticipate that the IMF will need to utilize and/or expand the recently activated New Arrangements to Borrow (NAB), to which the United States has pledged more than \$100 billion to date?

Answer. The IMF has sufficient resources at this time to meet its members' needs for balance of payments support.

With the activation of the NAB in April, IMF resources currently available for new lending programs total almost \$400 billion.

Currently, no additional Eurozone members are requesting IMF support. It is important to keep in mind that the bulk of the financing for European crisis countries has been provided by Europe, and that in these cases the IMF typically has only provided about one-third of the total financial support.

Question. On March 29, out of profound concern that the administration is not fully and faithfully enforcing CISADA, Senators Kyl, Lieberman, and I sent an unclassified letter to Secretary Clinton and to you with a 54-page classified annex detailing additional sanctions violations of which we are aware. Can you commit to a date when we can expect a response to this letter?

Answer. In addition to the unclassified response letter sent on May 2, my staff provided a classified briefing on CISADA matters on May 19.

Question. As you know, section 104 of CISADA "urges the President, in the strongest terms, to consider immediately using the authority of the President to impose sanctions on the Central Bank of Iran." According to CRS, authorities for such a designation "could include section 311 of the USA PATRIOT Act (31 U.S.C. 5318A), which authorizes designation of foreign banks as "of primary money laundering concern." Do you plan to impose sanctions on the Central Bank of Iran (CBI)?

Answer. United States financial institutions are prohibited, with very limited exceptions, from doing any business directly or indirectly with all Iranian banks, including the CBI. Treasury recognizes that section 104 of CISADA urges us to consider imposing sanctions on CBI, and along with our colleagues in the administration, has been considering a range of possible actions. This follows on several years of intense focus by Treasury on the CBI. We have, for example, highlighted our concerns regarding the CBI's conduct in FinCEN advisories on two occasions. Treasury also has noted previously that the CBI and Iranian commercial banks have requested that their names be removed from global transactions to make it more difficult for intermediary financial institutions to determine the true parties in the transaction, and we remain concerned that the CBI may be facilitating transactions for sanctioned Iranian banks. That said, designating a central bank would be a very significant step, with ramifications that may well extend far beyond a similar action against a commercial bank. For such an action to have the desired effect, it is essential that we obtain the cooperation of our allies to ensure that it increases the pressure on Iran. We continue to monitor the activities of the CBI and to work closely with our allies on the full range of pressures we can bring to bear on Iran.

SUBCOMMITTEE RECESS

Senator DURBIN. Thank you, Senator Moran.

And thank you, Mr. Secretary.

The record of this hearing remains open for a period of 1 week, until noon on Tuesday, April 12. Subcommittee members may submit statements or questions for the Secretary to consider.

And this hearing of the subcommittee stands recessed.

[Whereupon, at 11:25 a.m., Tuesday, April 5, the subcommittee was recessed, to reconvene subject to the call of the Chair.]

MATERIAL SUBMITTED SUBSEQUENT TO THE HEARING

[CLERK'S NOTE.—The following testimony(ies) were received subsequent to the hearing for inclusion in the record.]

PREPARED STATEMENT OF POLICYLINK, THE FOOD TRUST, AND THE REINVESTMENT FUND

Chairman and distinguished Senators of the subcommittee, thank you for the opportunity to share our support for a Healthy Food Financing Initiative (HFFI). PolicyLink is a national research and action institute advancing economic and social equity by Lifting Up What Works®; The Food Trust is a nonprofit organization working to ensure that everyone has access to affordable, nutritious food; and The Reinvestment Fund is a Community Development Financial Institution (CDFI) that creates wealth and opportunity for low-wealth people and places through the promotion of socially and environmentally responsible development.

Our three organizations, along with a diverse coalition of stakeholders, which includes representatives from the grocery industry, health, civil rights, agriculture and the community development finance community, support the creation of HFFI to address the problem of “food deserts” in urban and rural areas across the Nation. This problem can be solved in many communities using a successful model that is underway in the State of Pennsylvania and is now being replicated throughout the country.

HFFI is a program worthy of investment as it promotes health, creates jobs, and sparks economic development. HFFI will provide loan and grant financing to attract grocery stores and other fresh food retail to underserved urban, suburban, and rural areas, and renovate and expand existing stores so they can provide the healthy foods that communities want and need. Over time, with continued investment, HFFI could solve the problem of food deserts in urban and rural communities across the country.

For decades, low-income communities, particularly communities of color, have suffered from a lack of access to healthy, fresh food. USDA research determined that more than 23.5 million Americans are living in communities without access to high-quality, fresh food. Studies repeatedly show that residents of many low-income neighborhoods must travel long distances for healthy food, or rely on corner stores and fast food outlets offering high-fat, high-sugar foods. For instance, a recent multistate study found that low-income census tracts had half as many supermarkets as wealthy tracts, and four times as many smaller grocery stores. Another multistate study found that 8 percent of African Americans live in a tract with a supermarket, compared to 31 percent of whites. Nationally, low-income ZIP codes have 30 percent more convenience stores, which tend to lack healthy food, than middle income ZIP codes.

And, a nationwide analysis found there are 418 rural food desert counties where all residents live more than 10 miles from a supermarket or a supercenter—this is 20 percent of rural counties. In rural communities, inadequate transportation can be a particular challenge. In Mississippi, which has the highest obesity rate of any State, more than 70 percent of food stamp eligible households travel more than 30 miles to reach a supermarket. Adults living in rural Mississippi food desert counties are 23 percent less likely to consume the recommended fruits and vegetables than those in counties that have supermarkets, controlling for age, sex, race, and education.

Controlling for population density, rural areas have fewer food retailers of any types compared to urban areas, and only 14 percent the number of chain supermarkets. For instance, in New Mexico, rural residents have access to fewer grocery stores than urban residents, pay more for comparable items, and have less selection. The same market basket of groceries costs \$85 for rural residents versus \$55 for urban residents.

The results of this lack of healthy food options are grim—these communities have significantly higher rates of obesity, diabetes, and other related health issues. Over the past decade, obesity rates have more than doubled in children and tripled in adolescents. In 2010, PolicyLink and The Food Trust conducted a review of more than 130 studies on the issue of access to healthy food and found a direct correlation between diet-related diseases and access. A California study found that obesity and diabetes rates were 20 percent higher for those living in the least healthy “food environments.” In Indianapolis, a study found that BMI values corresponded with access to supermarkets and fast food restaurants. Researchers estimated that adding a new grocery store to a high-poverty neighborhood translates into a 3-pound weight decrease.

Fortunately, changing access changes eating habits. For every additional supermarket in a census tract, produce consumption increases 32 percent for African Americans and 11 percent for whites, according to a multistate study. A survey of produce availability in New Orleans’ small neighborhood stores found that for each additional meter of shelf space devoted to fresh vegetables, residents eat an additional .35 servings per day. In fact, of 14 studies that examine food access and consumption of healthy foods, all but one of them found a correlation between greater access and better eating behaviors. This is also true for food stamp recipients. Proximity to a supermarket was found to be associated with increased fruit and vegetable consumption.

The problems associated with lack of access go beyond health. Low-income communities are cut off from all the economic development benefits that come with a local grocery store: the creation of steady jobs at decent wages and the sparking of complementary retail stores and services nearby. Grocery stores operate as important economic anchors for communities, providing a vital service and bringing customers that can also support other nearby business. Securing new or improved local grocery stores can improve local economies and create jobs.

President Barack Obama’s proposed fiscal year 2012 budget includes a proposal to invest \$330 million, including \$250 million in New Markets Tax Credits, in a national HFFI. Specifically, the Initiative would provide:

- \$35 million through USDA’s Office of the Secretary, with additional “other funds of Rural Development and the Agricultural Marketing Service available to support the USDA’s portion of the Healthy Food Financing Initiative”;
- \$25 million through the Treasury Department’s CDFI Fund
- \$20 million through Health and Human Services
- \$250 million through the Treasury Department’s New Markets Tax Credits Program.

An HFFI would attract investment in underserved communities by providing critical loan and grant financing. These one-time resources will help fresh food retailers overcome the higher initial barriers to entry into underserved, low-income urban and rural communities, and would also support renovation and expansion of existing stores so they can provide the healthy foods that communities want and need. The program would be flexible and comprehensive enough to support innovations in healthy food retailing and to assist retailers with different aspects of the store development and renovation process.

Grocery industry representatives find that there are obstacles to grocery store development in underserved low-income communities, but also that those obstacles can be overcome. The development process for building a new grocery store is lengthy and complex, and retailers often find that stores in low-income communities have high start-up costs, appropriate sites are hard to find, and securing financing is difficult. Grocery operators in both urban and rural areas cite lack of access to flexible financing as one of the top barriers hindering the development of stores in underserved areas.

HFFI is modeled after the successful Pennsylvania Fresh Food Financing Initiative (FFFI), a public/private partnership launched in 2004. Using a State investment of \$30 million, the program has led to:

- projects totaling more than \$190 million;
- 88 stores built or renovated in underserved communities in urban and rural areas across the State;
- improved access to healthy food for more than 400,000 residents;
- more than 5,000 jobs created or retained;
- increased local tax revenues; and
- much-needed additional economic development in these communities.

Stores range from full-service 70,000 square foot supermarkets to 900 square foot food shops; and from traditional grocery stores to farmers’ markets, cooperatives, and corner stores selling healthy food. Approximately two-thirds of the projects were in rural areas and small towns with the remainder in urban areas.

HFFI is a viable, effective, and economically sustainable solution to the problem of limited access to healthy foods. It can bring triple bottom-line benefits, achieving multiple goals: reducing health disparities and improving the health of families and children; creating jobs; and, stimulating local economic development in low-income communities.

HFFI would incorporate the key components that allowed the Pennsylvania program to be so effective at attracting private dollars, garnering the commitment of store operators, getting fresh food retail stores and markets successfully developed, and stimulating local economies.

The Pennsylvania FFFI has been cited as an innovative model by the U.S. Centers for Disease Control and Prevention; the National Conference of State Legislatures; Harvard's Kennedy School of Government; and the National Governors Association. There is significant momentum in many States and cities across the country to address the lack of grocery access in underserved communities. Several States and/or cities are in the process of replicating the successful Pennsylvania FFFI Program, and many others have begun to examine the needs and opportunities in their communities. For example:

- The State of New York has launched the Healthy Food, Healthy Communities Initiative, a business financing program to encourage supermarket and other fresh food retail investment in underserved areas throughout the State that will provide loans and grants to eligible projects. New York City has launched a complementary FRESH Program that will encourage supermarket development through tax and zoning incentives and a single point of access to city government for supermarket operators.
- The City of New Orleans recently launched the Fresh Food Retailer Initiative Program (FFRI) that will provide direct financial assistance to retail businesses by awarding forgivable and/or low-interest loans to grocery stores and other fresh food retailers.
- The California Endowment, NCB Capital Impact, and other community, supermarket industry, and government partners have been working to create a supermarket financing program in California that is expected to be launched in the first half of 2011.

A national HFFI could amplify the impact in each of these States and leverage the work already underway to ensure swift implementation. Moreover, a national HFFI would ensure that all State and communities could solve their food desert problems with new stores and other healthy food retail projects.

In the midst of our current economic downturn, the need for a comprehensive Federal policy to address the lack of fresh food access in low-income is critical. We urge the subcommittee to support full funding for a Healthy Food Financing Initiative, for the benefit of communities across the Nation. Thank you for the opportunity to share our perspectives with you today.

FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2012

WEDNESDAY, MAY 4, 2011

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 10:17 a.m., in room SD-138, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.

Present: Senators Durbin, Lautenberg, and Moran.

COMMODITY FUTURES TRADING COMMISSION

STATEMENT OF HON. GARY GENSLER, CHAIRMAN

OPENING STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. Good morning. I'm pleased to convene this hearing to consider the fiscal year 2012 funding request of two key Federal regulatory agencies within the jurisdiction of the Senate Committee on Appropriations Subcommittee on Financial Services and General Government—the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC). Before I go further, let me apologize for being a few minutes late, but I opened a session this morning and it took a few minutes to get that started.

I welcome my distinguished Ranking Member, Senator Jerry Moran, other colleagues who've joined me on the dais today, and others that may arrive during the course of the proceeding.

Joining us today to present testimony on the critical work of these agencies; to share how they've used the resources provided over the past several years; and to explain the details of their budgetary needs for the next fiscal year, are the Honorable Gary Gensler, chairman of the CFTC, and the Honorable Mary L. Schapiro, chairman of the SEC.

The subcommittee has received a statement for the record from Colleen M. Kelley, president of the National Treasury Employees Union, regarding the funding for the SEC. And if there's no objection, I ask that it be included in the record of these proceedings.

CRITICAL MARKET OVERSIGHT

The CFTC and the SEC both occupy pivotal positions at the forefront of stimulating and sustaining economic growth and prosperity in America, while protecting the marketplace from fraud and ma-

nipulation. Market users, financial investors, and the U.S. economy rely on the vigilant oversight of these two agencies in today's rapid-paced, evolving, and often volatile, global marketplace.

It's clear that Chairman Gensler and Chairman Schapiro, their fellow commissioners, and their respective staff, have invested inestimable hours in paving the way toward a more reliable regulatory foundation—one that will safeguard the stability and integrity of the futures and securities markets. Particularly at this time in history, we depend on their foresight and leadership to implement promptly, prudently, and transparently the array of comprehensive reforms designed to strengthen our regulatory framework.

CFTC MISSION

The CFTC carries out market surveillance, compliance, and enforcement in the futures arena. It detects, deters, and punishes abusive trading activity and the manipulation of commodity prices which could have a negative impact on consumers and the economy.

Adding to the challenge of the CFTC's mission is a significantly transformed, globalized, electronic, around-the-clock, and highly diversified marketplace. With the enactment of the Dodd-Frank Act financial regulatory reform, the CFTC's mission was substantially expanded to embrace oversight of the swaps marketplace, the vast, once-in-the-shadows world of over-the-counter (OTC) derivatives.

To grasp the vast scope of the CFTC's additional responsibility, it's useful to consider the long-regulated U.S. futures marketplace, historically policed by the CFTC, that has the notional value of approximately \$40 trillion—enormous by anyone's calculation. It pales in comparison to the U.S. OTC derivatives marketplace now coming under the CFTC's purview, with a notional value not of \$40 trillion, but \$300 trillion—nearly eight times the amount of the regulated futures market.

SEC MISSION

As the investor's advocate, the SEC is responsible for maintaining fair, orderly, and efficient stock and securities markets. The SEC conducts day-to-day oversight of major market participants, monitors corporate disclosure of information to the public, and investigates and pursues civil and criminal enforcement actions.

To fulfill its market oversight and investor protection functions, the SEC must monitor 1,800 investment advisers, 7,500 mutual funds, and more than 5,000 broker-dealers with more than 160,000 branch offices. The SEC reviews the disclosures and financial statements of approximately 10,000 reporting companies, oversees approximately 500 transfer agents, 15 national securities exchanges, 9 clearing agencies, and 10 nationally recognized statistical rating organizations.

With the enactment of the Dodd-Frank Act last July, the SEC's responsibilities grew dramatically. Now the SEC is in the driver's seat for issuing 100 new rules; creating 5 new offices; producing more than 20 studies and reports; overseeing OTC derivatives markets and hedge fund advisers; registering municipal advisers and security-based swap market participants; enhanced supervising of Nationally Recognized Statistical Rating Organizations and clear-

ing agencies; regulating asset-backed securities; and creating a new whistleblower program.

BUDGETARY NEEDS

I welcome the opportunity today to look at the critical budgets of these two very, very important agencies. I am pleased that during the past several years that I've been honored to chair the subcommittee we have substantially and dramatically increased the funding of both of these agencies. In terms of resources in recent years, since fiscal year 2007 funding for the CFTC has increased from \$97.9 million to the \$202.6 million recently enacted in the fiscal year 2011 continuing resolution—a 107 percent hike in funding over a 4-year period. The SEC's funding has grown from \$892 million in fiscal year 2007 to \$1.185 billion in fiscal year 2011—a 33 percent hike in funding in that time span.

Compared to the allocation available to the subcommittee last July when we prepared our recommendations, we experienced a significantly reduced overall level for purposes of funding the decisions for the recently enhanced fiscal year 2011 full year continuing resolution. Encountering a substantial reduction in our available funds of more than \$3.5 billion, representing a 13 percent cut below what we had to work with last July, was far from ideal.

It also meant an overall decrease of \$2.35 billion, or 10 percent below a freeze at the fiscal year 2010 enacted level, making for some tough choices. The fiscal year 2012 forecast does not look rosy. I fully expect to face equally complicated and challenging funding requirements.

PREPARED STATEMENT

I'm going to ask that the remainder of my statement be placed in the record, and I'd like to now turn it over to my Ranking Member, Senator Moran of Kansas, for any opening remarks he might have.

[The statement follows:]

PREPARED STATEMENT OF SENATOR RICHARD J. DURBIN

Good morning. I am pleased to convene this hearing to consider the fiscal year 2012 funding requests of two key Federal regulatory agencies within the jurisdiction of the Appropriations Subcommittee on Financial Services and General Government: the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC).

I welcome my distinguished ranking member, Senator Jerry Moran, and other colleagues who have joined me on the dais today, and others who may arrive during the course of these proceedings.

Joining us today to present testimony on the critical work of their agencies, to share how they have used the resources provided over the past couple years, and to explain the details of their budgetary needs for fiscal year 2012 are the Honorable Gary Gensler, Chairman of the CFTC and the Honorable Mary L. Schapiro, Chairman of the SEC.

The CFTC and the SEC both occupy pivotal positions at the forefront of stimulating and sustaining economic growth and prosperity in our country—while protecting the marketplace from fraud and manipulation.

Market users, financial investors, and the U.S. economy rely on vigilant oversight by these two agencies in today's rapid-paced, evolving, and often volatile global marketplace.

It is clear that both Chairman Gensler and Chairman Schapiro, their fellow Commissioners, and their respective staff have invested inestimable hours in paving the way toward a more reliable regulatory foundation—one that will safeguard the sta-

bility and integrity of the futures and securities markets. Particularly at this time in history, we depend on their foresight and leadership to promptly, prudently, and transparently implement the array of comprehensive reforms designed to strengthen our regulatory framework.

The CFTC carries out market surveillance, compliance, and enforcement programs in the futures arena. The CFTC detects, deters, and punishes abusive trading activity and manipulation of commodity prices, which could have negative impacts on consumers and the economy.

Adding to the challenge of the CFTC's mission is a significantly transformed, globalized, electronic, round-the-clock, and highly diversified marketplace. With the enactment of Dodd-Frank financial regulatory reform, the CFTC's mission was substantially expanded to embrace oversight of the swaps marketplace—the vast “once-in-the-shadows” world of over-the-counter (OTC) derivatives.

To grasp the vast scope of the CFTC's additional responsibilities, it is useful to consider that the long-regulated U.S. futures marketplace historically policed by the CFTC has a notional value of approximately \$40 trillion. Enormous—by anyone's calculation. But it pales in comparison to the U.S. OTC derivatives marketplace now coming under the CFTC's purview—with a notional value estimated at \$300 trillion—nearly eight times the notional amount of the regulated futures markets.

As the “investors advocate,” the SEC is responsible for maintaining fair, orderly, and efficient stock and securities markets. The SEC conducts day-to-day oversight of the major market participants, monitors corporate disclosure of information to the investing public, and investigates and pursues civil and criminal enforcement actions against securities law violations.

To fulfill its market oversight and investor protection functions, the SEC must monitor 1,800 investment advisers, 7,500 mutual funds, and more than 5,000 broker-dealers with more than 160,000 branch offices. The SEC reviews the disclosures and financial statements of approximately 10,000 reporting companies, oversees approximately 500 transfer agents, 15 national securities exchanges, 9 clearing agencies, 10 nationally recognized statistical rating organizations (NRSROs), as well as the Public Company Accounting Oversight Board, Financial Industry Regulatory Authority, Municipal Securities Rulemaking Board, and the Securities Investor Protection Corporation.

With the enactment of the Dodd-Frank Act last July, the SEC's responsibilities grew considerably. Now the SEC is in the driver's seat for issuing 100 new rules, creating five new offices, producing more than 20 studies and reports, overseeing the over-the-counter derivatives market and hedge fund advisers; registering municipal advisers and security-based swap market participants; enhanced supervising of NRSROs and clearing agencies; regulating asset-backed securities; and creating a new whistleblower program.

I welcome the opportunity today to conduct critical oversight of these two agencies through a candid discussion of where they are today, where they need to be, and how we can work to provide resources they need to satisfy their vital missions.

I am pleased that over the past several years, this subcommittee has been able to substantially boost the funding approved for the CFTC and the SEC to help address pressing resource needs.

In terms of resources in recent years, since fiscal year 2007, funding for the CFTC has increased from \$97.981 million to the \$202.675 million recently enacted in the fiscal year 2011 continuing resolution, a 107 percent hike in funding. The SEC's funding has grown from \$892.6 million in fiscal year 2007 to \$1.185 billion in fiscal year 2011, a 33 percent hike in funding over the time span.

Compared to the allocation available to this subcommittee last July when we prepared our fiscal year 2011 recommendations, we experienced a significantly reduced overall level for purposes of funding decisions for the recently enacted fiscal year 2011 full-year continuing resolution. Encountering a substantial reduction in our available funds of more than \$3.5 billion, representing a 13 percent cut, below where we were last July was far from ideal. It also meant an overall decrease of \$2.35 billion, or 10 percent, below a freeze at the fiscal year 2010 enacted level—making for many tough choices and painful sacrifices.

The fiscal year 2012 forecast does not look rosy. I fully expect to face equally complicated and challenging funding decisions as we prepare our bill for the ensuing fiscal year.

Looking ahead, for fiscal year 2012, the President seeks funding of \$308 million for the CFTC, an increase of \$105 million (52 percent) more than the fiscal year 2011 enacted level of \$206.7 million, which itself is an increase of \$33.98 million, a 20 percent hike, above the fiscal year 2010 enacted level of \$168.8 million.

For the SEC, the President's fiscal year 2012 budget seeks base funding of \$1.407 billion. This is an increase of \$222.5 million (19 percent) above the fiscal year 2011

enacted level of \$1.185 billion, not including an additional \$33 million in prior-year unobligated balances. The fiscal year 2011 base funding represents an increase of \$74 million, or 7 percent, more than the fiscal year 2010 enacted level of \$1.111 billion.

Oversight Responsibility.—The Congress probably exercises its most effective oversight of agencies and programs through the appropriations process. It allows an annual check-up and review of operations and spending. Today's hearing provides a valuable opportunity to ask some key questions:

- Are the CFTC and the SEC keeping pace with developments in the markets particularly the emerging prevalence of new-fangled, more complex financial products?
- Do these agencies have the right mix of talent and specialized expertise to be vigilant watchdogs rather than timid lap dogs?
- Are they ahead of the curve, rather than trailing behind, when it comes to stopping unscrupulous, greed-driven schemers who pursue selfish gain at the expense of the unwary and unwitting?
- Do they have nimble, state-of-the-art, sophisticated information technology to augment and support their human capital?
- What are the likely consequences of budget belt-tightening and possibly reduced resources?

I look forward to hearing more about what each of these agencies have been able to accomplish since our last hearing, what resource gaps remain to be filled to make them more robust, responsive regulators, and how do we best get there amid growing deficits and spending cut sentiments.

It will be helpful to hear from both Chairmen their honest appraisals about the resources they will require to achieve their missions, keep pace with change, and become as sophisticated as, if not more so, than the entities they monitor—while responsibly managing taxpayer dollars.

STATEMENT OF SENATOR JERRY MORAN

Senator MORAN. Chairman Durbin, thank you very much. Thank you for your kindness and your graciousness to me, and thank you for calling this hearing.

And I welcome the two chairmen, Chairman Gensler and Chairman Schapiro.

As we review the budget submissions for the CFTC and the SEC for fiscal year 2012, I look forward to hearing the details of your requests, your plans to carry out your core missions, and how you propose to implement the Dodd-Frank Act.

Chairman Gensler, as you have said, derivative markets and effective oversight of those markets matter to corporations, farmers, homeowners, and small businesses. We all benefit from effective oversight that promotes fair and orderly derivative markets.

However, to promote such markets and to assist the businesses that are dependent upon them, we must also have an orderly and transparent process which outlines how they should work.

I have heard many concerns expressed that the CFTC is moving too quickly and has not adequately established the cost of new regulations, valuing speed over deliberation. I was pleased to see the CFTC acted last week to give the public more time to comment on the new regulations that you are proposing. While I welcome this extension, I also think that rules have been proposed in a sequence that has created some confusion.

I've heard Chairman Gensler's recent comment about how the CFTC has revealed its mosaic of rules. However, I think a roadmap for implementation, rather than a random mosaic of rules, would be more helpful in getting us on the path to a fair and orderly marketplace and help us establish appropriation priorities. This call for a roadmap is intended to foster transparency and broaden under-

standing, and for any new regulatory framework to be effective, everyone involved must have a clear appreciation of their roles and responsibilities in the new system and how these changes will evolve in a logical sequence.

In reviewing the budget requests of both the CFTC and the SEC, we recognize that protecting investors is important as first-time investors have turned to markets to help secure their retirements, pay for homes, and send their children to college. We also understand that your agencies are faced with innovations in the financial services arena that present regulators with increasingly complex markets to regulate. However, we're all aware of our budget deficit and fiscal constraints that will require all agencies to make decisions as to how best to allocate resources.

Technological solutions will be necessary to keep up with the next generation of trading platforms and systems that operate at record-breaking pace. Staffing levels will have to be carefully considered so that they do not become unsustainable. This is not a new challenge. All agencies should be making strategic decisions on resource allocations driven by the agency's mission responsibilities, and grounded in analysis of their workload and their human capital resources and needs. Simply increasing funding does not ensure that an agency can successfully achieve its mission.

In addition to making wise decisions about how to strike a balance between investments in new technology and staffing levels, agencies also must make sound decisions about what type of staff to hire and how best to utilize those positions. In reviewing the recent Inspector General (IG) report on the CFTC rulemaking process, I have concerns about how the CFTC has chosen to utilize staff the last year. For instance, as discussed in the IG report, the CFTC has ineffectively used its Office of the Chief Economist. Not only was this office left unfilled for nearly a year, but the CFTC went on a hiring spree for new lawyers during the same time. The IG report suggests that unless the CFTC can make a wiser hiring decision and engage in meaningful economic analysis, the Congress may need to provide additional direction on how the commission can spend money on hiring and how it should utilize its staff.

In addition to the budget concerns I have another one is that the CFTC, despite tight budget deficits, has engaged in rulemakings that are discretionary and unnecessary according to the CFTC—the only economic analysis available. For example, proposed rulemakings on position limits and core principles are not required by the Dodd-Frank Act. This is not necessary for the CFTC to immediately move toward these rulemakings. Furthermore, the only reliable quantitative data available from the CFTC is a staff report that suggests such rules are unnecessary and, at most, premature. Pursuit of position limits and core principle rulemakings are direct examples of how the CFTC has failed to listen to the economist and failed to prioritize rulemakings under existing budget constraints.

PREPARED STATEMENT

Chairman Gensler and Chairman Schapiro, you both have challenges—significant ones—in front of you. You must improve transparency in our securities market and uncover fraud and deception,

while not over-regulating our markets and hindering our economic recovery.

Chairman Durbin, I look forward to working with you as we consider the fiscal year 2012 budget requests for the CFTC and the SEC. Thank you.

[The statement follows:]

PREPARED STATEMENT OF SENATOR JERRY MORAN

Mr. Chairman, thank you for calling this hearing. Chairman Gensler and Chairman Schapiro, welcome.

As we review the budget submissions for the Commodity Futures Trading Commission's (CFTC) and the Security and Exchange Commission (SEC) for fiscal year 2012, I look forward to hearing the details of your requests, your plans to carry out your core missions, and how you propose to implement the Dodd-Frank Act.

Chairman Gensler, as you have said, "derivatives markets and effective oversight of those markets matters to corporations, farmers, homeowners and small businesses." We all benefit from effective oversight that promotes fair and orderly derivatives markets. However, to promote such markets and assist the businesses that are dependent on them, we must also have an orderly and transparent process which outlines how they should work. I have heard many concerns expressed that the CFTC is moving too quickly and has not adequately established the cost of new regulations, valuing speed over deliberation. I was pleased to see that the CFTC acted last week to give the public more time to comment on the new regulations you are proposing. While I welcome this extension, I also think rules have been proposed in a sequence which has created confusion. I have heard Chairman Gensler's recent comment about how the CFTC has revealed its "mosaic" of rules. However, I think a roadmap for implementation, rather than a random mosaic of rules, would be more helpful in getting us on the path to a fair and orderly marketplace and help establish appropriations.

This call for a road map is intended to foster transparency and broaden understanding. For any new regulatory framework to be effective, everyone involved must have a clear understanding of their roles and responsibilities in the new system and how those changes will evolve in a logical sequence.

In reviewing the budget request of the both the CFTC and the SEC, we recognize that protecting investors is important as first-time investors have turned to the markets to help secure their retirements, pay for homes, and send their children to college. We also understand that your agencies are faced with innovations in the financial services arena that present regulators with increasingly complex markets to regulate.

However, as we are all aware, our budget deficit and fiscal constraints will require all agencies to make decisions as to how to best allocate resources. Technological solutions will be necessary to keep up with next generation trading platforms and systems that operate at a record-breaking pace. Staffing levels will have to be carefully considered so that they do not become unsustainable. This is not a new challenge. All agencies should be making strategic decisions on resource allocation driven by the agency's mission responsibilities, and grounded in analysis of their workload and their human capital resources and needs. Simply increasing funding does not ensure that an agency can successfully achieve its mission.

In addition to making wise decisions about how to strike a balance between investments in new technology and staffing levels, agencies must also make sound decisions about what type of staff to hire and how best to utilize those positions. In reviewing a recent Inspector General (IG) report on the CFTC rulemaking process, I have concerns about how the CFTC has chosen to utilize staff over the last year. For instance, as discussed in the IG report, the CFTC has ineffectively used the Office of the Chief Economist. Not only was this office left unfilled for nearly a year, but the CFTC went on a hiring spree for new lawyers during the same time. The IG report suggests that unless the CFTC can make wiser hiring decisions and engage in meaningful economic analysis, the Congress may need to provide additional direction about how the CFTC can spend money on hiring and how it should utilize its staff.

An addition to budget concern I have is that the CFTC, despite tight budgets, has engaged in rulemakings that are discretionary and unnecessary, according to the only the CFTC economic analysis available. For example, proposed rulemakings on position limits and core principles are not required by Dodd Frank. Thus, it is not necessary for the CFTC to immediately move forward with these rulemakings. Furthermore, the only reliable quantitative data available from the CFTC is a staff re-

port that suggests such rules are unnecessary and at most premature. Pursuit of position limits and core principle rulemakings are direct examples of how the CFTC has failed listen to its economists and failed to prioritize rulemakings under existing budget constraints.

Chairman Gensler and Chairman Schapiro, you both have challenging tasks in front of you. You must improve transparency in our securities markets and uncover fraud and deception, while not over-regulating our markets and hindering our economic recovery.

Chairman Durbin, I look forward to working with you as we consider the fiscal year 2012 budget requests of the CFTC and the SEC.

Senator DURBIN. Thank you Senator Moran.
Senator Lautenberg.

STATEMENT OF SENATOR FRANK R. LAUTENBERG

Senator LAUTENBERG. Mr. Chairman, thanks very much for holding the hearing and I ask for unanimous consent that my full statement will be included in the record.

Senator DURBIN. Without objection.

Senator LAUTENBERG. And I take a moment of that time to just say that, how pleased I am to see each of you in your positions. And how delighted I am—delight's the wrong word—how satisfied I am that we're on to something, that we're going to change the way we did business in the past as a result of the finance reform legislation, to make sure that companies understand that there are obligations that they're going to have to meet.

And I look at history. I used to run a company, a very big company—ADP. ADP does the Bureau of Labor statistics every month now, and the company pays more than 35 million people their paychecks and has fresh data to work from. And I learned something as the CEO of that company. As the company grew, I learned that the most satisfied investors are those who see a transparent approach to what's going on in the company. And I see that, the shortcuts to increased compensation without regard for the performance of the company or of the need of the employees.

I furnished the Columbia Business School, my alma mater, with a chair. The chair was endowed in 2001, when I was out of the Senate for 2 years, and the chair was to say that we have to pay more attention to business ethics and corporate governance. And I point out without patting myself too hard on my, on the shoulder, that, that was in 2001, my friends. It was 2001, which preceded 2008 by a long time.

PREPARED STATEMENT

And so, I'm pleased to see that we're finally going to say—hey, you can't get away with the kinds of things that you did before. The public's entitled to know what happens when they put money into an investment, and it's our responsibility to help guide them—and not worry so much about whether we're overburdening, but I worry about whether we're underburdening the, your respective agencies and letting things go back to where they were. That should never happen again in America. And I'm going to fight like the devil to make sure you have the resources to do your job with.

[The statement follows:]

PREPARED STATEMENT OF SENATOR FRANK R. LAUTENBERG

Mr. Chairman, each week brings another reminder that our country is slowly—but steadily—recovering from the worst economic downturn since the Great Depression.

Letting Wall Street regulate itself helped trigger this crisis, sending millions of Americans to the unemployment line and causing their retirement accounts to shrink.

Under President Obama's leadership, we're rebuilding the economy from the ground up—laying a foundation that will make our country stronger and better prepared for the future.

The cornerstone of this effort is last year's Wall Street reform law, which includes critical safeguards to protect the economy from another meltdown.

This new law reins in the recklessness of the big banks and creates a watchdog to look out for consumers and make sure financial institutions follow the rules.

In addition, these reforms ensure that ordinary investors get the information they need to make sound decisions—and bring the secretive derivatives market out of the shadows and into the sunlight.

Unfortunately, House Republicans have been persuaded by their friends on Wall Street that the financial industry can regulate itself.

They are trying to stop Wall Street reform by gutting funding for the new law. Make no mistake: without these new reforms and the funding to carry them out, Wall Street will return to its reckless ways, which will threaten our economic recovery and undermine our ability to create jobs.

As a former CEO, I understand the need for a strong financial sector.

But nothing is more important than putting people back to work and making sure that our economy is never again threatened by the risky bets of Wall Street gamblers.

So I look forward to hearing from today's witnesses about how we can make sure the reform law works the way it was designed and protects the American economy and the American people.

Senator LAUTENBERG. Thank you very much.

Senator DURBIN. Thanks a lot, Senator Lautenberg.

And we'd like to invite our guests to make an opening statement if they'd care to.

Mr. Gensler.

SUMMARY STATEMENT OF GARY GENSLER

Mr. GENSLER. Good morning. Thank you, Chairman Durbin, Ranking Member Moran, and members of the subcommittee. I thank you for inviting me to testify on behalf of the CFTC about the 2012 budget request.

I'm honored also to testify along with SEC Chair, Mary L. Schapiro, with whom we've worked very closely to implement the Dodd-Frank Act, and many other matters.

The CFTC is a good investment for the American public. And though the CFTC is not a price-setting agency, rising prices for basic commodities, agriculture, energy and the like, highlight the importance of having effective market oversight to ensure integrity and transparency.

Each part of our Nation's economy relies on a well-functioning derivatives marketplace. It's essential, as producers, merchants, and other end-users manage their risk. In essence what it does is allows a company to lock in a price at some future date. That's at the core of what we oversee.

This price certainly allows companies to better invest and plan for their business. The business certainty that derivatives markets can provide exists to the degree only that people have confidence in the integrity of the markets, however. And the CFTC was created to oversee futures markets—first in the agriculture markets,

later other commodities. But, of course, in the 1980s came along the swaps marketplace, and this new type of derivatives remained unregulated until the Dodd-Frank Act. With the passage of the Dodd-Frank Act, the U.S. swaps market, as the chairman noted—nearly \$300 trillion in size, or roughly seven times the size of what we currently oversee—largely comes under our jurisdiction. Some of it, of course, is over at the SEC.

So, we're working deliberately and efficiently, and I believe transparently, to put in place the rules that the Congress directed us to do. We've now at this point substantially completed that process. And as the Ranking Member said, we have the mosaic out, and we are allowing the public to look at that whole mosaic. We'll only move forward with final rules after we summarize the comments—and with 16,000 comments in, that's going to take some time to summarize and get commissioner feedback—but I think we'll be moving on final rules throughout the summer and into the fall of this year.

As relates to the budget request of \$308 million that the President put forward, there are many priorities. I'd like to just highlight, very quickly, four. One is technology. The budget request builds upon the support of this subcommittee that gave us \$37 million in technology this year, to move up to \$66 million. The swaps marketplace being seven times the size of the futures marketplace, we need that information. And though the Dodd-Frank Act established something called Swap Data Repositories, we're faced with the responsibility of aggregating futures data with swaps data and bringing it together. And what's more—there may be more than one data repository by asset class. And so we'll have to aggregate that information so that we can police the markets, and we need the technology to make sure that we can do that.

Second, is the swap dealers themselves. The Dodd-Frank Act, for the first time, calls for comprehensive regulation of swaps dealers. To accomplish this, the CFTC will establish a new swap dealer and intermediary oversight program, or actually, division. We'll be moving some people over into this. But this area will need about 30 more staff, building upon a base of about 80 people that we currently have in that effort.

Third, is clearinghouses. The Dodd-Frank Act requires a mandate that swaps that are standardized enough, be in central clearing. We currently oversee about 15 clearinghouses. We think that will grow to 20 or 21. With that roughly 50 percent increase of clearinghouses and an eight-fold increase in the underlying product, we're asking for about 30 new staff, bringing the staff in our clearing oversight from 40 up to 70.

And then, last, among these four key priorities is transparency. The Dodd-Frank Act has real-time price reporting. It also has oversight of a new market mechanism called Swap Execution Facilities (SEFs). We're not entirely sure how many there will be. We think, our best estimate is at least 30 or 40 of these new SEFs. We believe that we need at least 60 additional staff, to oversee the markets. That jump is to about 100 in this area, but it's for real-time reporting and transparency.

Now, this is not to say we don't have other priorities—enforcement, overseeing position limit authority, market surveillance—but

overall it's bringing our staff up from about 720, where we think we'll end this year, with your help with this \$202 million, to a request for 983 people.

PREPARED STATEMENT

We recognize this budget deficit for the Nation presents enormous challenges for this subcommittee and the Congress and the public, but we cannot forget that the 2008 crisis was very real, and it still is very real. Reform will only be effective once we've completed final rules, but, yes, also only after we have significant resources to fulfill this extended mission.

So, I thank you.

[The statement follows:]

PREPARED STATEMENT OF GARY GENSLER

Good morning Chairman Durbin, Ranking Member Moran and members of the subcommittee. I thank you for inviting me to today's hearing on the Commodity Futures Trading Commission's (CFTC) fiscal year 2012 budget request. I am pleased to testify on behalf of the Commission.

CFTC MISSION

The CFTC is a good investment for the American public, overseeing vast markets with a relatively small staff. At its core, the mission of the CFTC is to ensure the integrity and transparency of derivatives markets so that hedgers and investors may use them with confidence. Derivatives emerged as tools to allow producers and merchants to be certain of the prices of commodities that they planned to use or sell in the future. Derivatives markets are used to hedge risk and discover prices and work best when they are transparent and free from fraud and manipulation.

The CFTC historically has been charged with overseeing one part of the derivatives market—the commodity futures markets. These markets have been around for more than a century. Initially, there were futures on agricultural commodities, such as wheat, corn, and cotton. The markets have grown to include contracts on energy and metals commodities, such as crude oil, heating oil, gasoline, copper, gold and silver, and contracts on financial products, such as interest rates, stock indexes, and foreign currency. These markets—and our regulatory oversight—affect tens of thousands of farmers, ranchers, oil producers, corporations, municipalities, pension funds, and anybody else who wants to hedge a risk and get the benefits of transparent pricing in competitive markets.

Each part of our Nation's economy relies on a well-functioning derivatives marketplace. It is essential so that producers, merchants, and other end-users can manage their risks. It allows those companies to lock in prices for the future. Such price certainty allows companies to better make essential business decisions and investments. Thus, it is critical that market participants have confidence in the integrity of these price discovery markets.

Though the CFTC is not a price-setting agency, rising prices for basic commodities—agricultural and energy—highlight the importance of having effective market oversight that ensures integrity and transparency.

The CFTC fulfills its statutory mandate through market surveillance, industry oversight and enforcement. We pursue fraud, such as Ponzi schemes, and market manipulation. We oversee futures exchanges and clearinghouses. We process registration applications, rule reviews, appellate filings, and examinations of exchanges and clearinghouses. The CFTC is a cop on the beat that protects markets in commodities and derivatives from fraud, manipulation, and other abuses.

CFTC SCOPE

The CFTC and its predecessors have overseen the commodity futures markets since the 1920s. A new type of derivatives called swaps, however, came around in the 1980s and remained unregulated until the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). That legislation expanded the CFTC's oversight to, for the first time, include both the futures and swaps markets. It also gave the CFTC new regulatory responsibilities. The Securities and Exchange Commission (SEC) will have similar jurisdiction over the securities-based swaps markets.

The swaps market that Dodd-Frank tasks the CFTC with regulating has a notional amount roughly seven times the size of that of the futures market and is significantly more complex. The notional value of the U.S. futures market in December was approximately \$36 trillion. Based upon figures compiled by the Office of the Comptroller of the Currency, the largest 25 bank holding companies currently have \$277 trillion notional amount of swaps.

Further, Dodd-Frank expands the CFTC's regulatory authority to include new types of entities, such as swap dealers, swap execution facilities (SEFs), and swap data repositories (SDRs). The swaps market is more complex than the futures markets because it includes customized bilateral hedging arrangements. Whereas all futures trade on exchanges, some swaps will continue to be traded over-the-counter.

IMPLEMENTING THE DODD-FRANK ACT

The CFTC is working deliberately, efficiently, and transparently to implement the Dodd-Frank Act. At this point, as we have substantially completed the proposal phase of our rule-writing to implement the Dodd-Frank Act. Since the President signed the Dodd-Frank Act last July, the CFTC has promulgated rules covering all of the areas set out by the act for swaps regulation, with the exception of the Volcker Rule, for which the act set a different timeline.

With the substantial completion of the proposal phase of rule-writing, the public now has the opportunity to review the whole mosaic of rules. This will allow market participants to evaluate the entire regulatory scheme as a whole.

To further facilitate this process, last week the CFTC approved reopening or extending the comment periods for most of our Dodd-Frank proposed rules for an additional 30 days.

This time will allow the public to submit any comments they might have after seeing the entire mosaic at once. As part of this, I am hopeful that market participants will continue to comment about potential compliance costs as well as phasing of implementation dates to help the agency as we go forward with finalizing rules.

We will begin considering final rules only after staff can analyze, summarize and consider comments, after the Commissioners are able to discuss the comments and provide feedback to staff, and after the CFTC consults with fellow regulators on the rules.

One component that we have asked the public about is phasing of rule implementation. Over the last 2 days, CFTC staff has worked with the SEC staff to host a roundtable to hear directly from the public about the timing of implementation dates of Dodd-Frank rulemakings. We also opened a public comment file last month to hear specifically on this issue. The roundtable and public comments help inform the CFTC as to what requirements can be met sooner and which ones will take a bit more time.

FISCAL YEAR 2012 BUDGET REQUEST

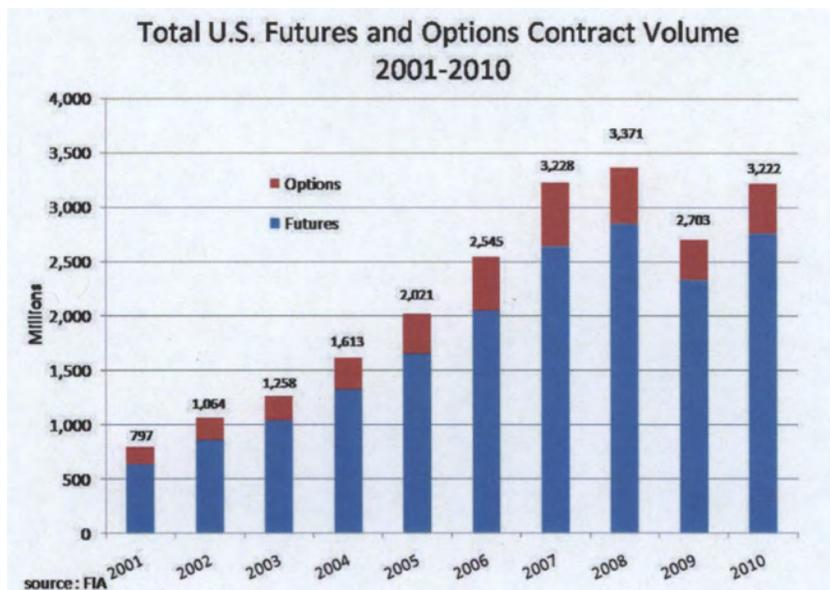
The President's budget proposes that \$308 million be appropriated for the CFTC for fiscal year 2012 to remain available until expended through fiscal year 2013. This funding level would enable the Commission to perform its responsibilities both in the oversight of commodity futures markets and in beginning to oversee the swaps markets.

In 2008, both the financial system and the financial regulatory system failed the test for the American public. Though there were many causes to the crisis, the unregulated swaps market played a central role. The President's budget request asks for \$106 million more than our fiscal year 2011 funding level because the 2008 financial crisis was very real, and the Congress mandated that regulation be brought to the swaps market. An investment in the CFTC is warranted, because, as we saw in 2008, without oversight of the swaps market, billions of taxpayer dollars may be at risk.

The CFTC's resources are used primarily on staff and technology.

The CFTC peaked in staff in 1992 at 634, but staff levels were cut nearly 25 percent in the early 2000s to our lowest level of approximately 440 in 2007 and 2008. With the help of the Congress, CFTC staffing levels just this past year returned to our levels of the late 1990s—the level needed to oversee the commodity futures markets at that time.

At the end of fiscal year 2010, the CFTC employed 682 thoughtful, experienced, and hardworking staff. In the last 10 years, however, futures trading volume has increased more than fourfold. The number of actively traded futures and options contracts increased more than ninefold. We have moved from an environment with open-outcry pit trading to highly sophisticated electronic markets.



The recently passed continuing resolution appropriates approximately \$202 million to the CFTC, which would allow the Commission to grow modestly to approximately 720 employees. The President's fiscal year 2012 budget request would provide funding for 983 employees. Though we are asking for an increase in funding to support approximately 37 percent more staff, it is in light of a congressional mandate that expands our scope more than sevenfold.



Effective oversight of the markets requires that we invest in both staff and technology. We need staff to process registration applications, conduct surveillance, and

rule enforcement reviews, investigate fraud and manipulation, and perform many other functions that computers alone cannot. But we also need technology to pursue automated surveillance to oversee the markets and to make our oversight more efficient.

Despite rapid advances in technology and the increased size of regulated derivatives markets, funding for the CFTC has lagged behind the growth of the markets. While market participants have the technology to automate their trading, we do not yet have the resources to employ modern technology to automate our surveillance.

Last year, we used about 18 percent of our budget—\$31 million—on technology initiatives. The continuing resolution requires that we allocate \$37.2 million toward technology in fiscal year 2011. The CFTC needs to make further investment in technology to efficiently oversee both the futures and swaps markets. Only through investment in the CFTC will we be able to adequately oversee the commodity futures and swaps markets and protect the American public. The President's fiscal year 2012 budget provides for \$66 million to be used on technology, which would increase the proportion of our budget used on technology to more than 21 percent.

To put the CFTC's funding request in perspective, I might note that the CFTC's fiscal year 2010 year-end staff of 682 compares to approximately 800,000 people employed by U.S. brokerage firms, according to the Department of Labor's Bureau of Labor Statistics. That is out of a financial industry that employs 5.6 million people. Furthermore, the CFTC's funding request of \$308 million compares to approximately \$814 billion in annual revenues of the top 25 bank holding companies according to industry filings with the Federal Reserve. The CFTC's technology budget of approximately \$31 million during fiscal year 2010 compares to about \$20–25 billion spent by U.S. broker/dealers on technology initiatives per year, according to a presentation recently given to the CFTC's Technology Advisory Committee by the TABB Group.

DETAILED FUNDING REQUEST

The requested funding increase to cover statutory authorities includes resources to accomplish the following goals:

Modernizing Information Technology and Establishing a New Group for Data.—The CFTC's fiscal year 2012 budget request includes \$66 million for technology. The requested budget includes \$41 million to fulfill our pre-Dodd-Frank information technology requirements. This increase allows the CFTC to invest in technology in an effort to keep pace with the futures marketplace that is becoming increasingly populated by algorithmic and high-frequency traders.

Technology will play a critical role in leveraging financial and human resources as the CFTC executes its expanded oversight and surveillance responsibilities pursuant to the Dodd-Frank Act. Accordingly, the CFTC will establish a new group for the collection, management, and analysis of data. This group will facilitate improved oversight and enforcement in the derivatives markets through the use of technology and data. It also will serve as the primary interface for market participants in adapting to the new data standards and reporting requirements for market data required under Dodd-Frank.

The CFTC's fiscal year 2012 budget request includes \$25 million for technology needed to implement Dodd-Frank. The resources requested are necessary for the CFTC to invest in direct data links to SDRs that are being established in the United States and internationally. The CFTC also must have the technology to aggregate and summarize the data for purposes of oversight and surveillance.

Establishing and Staffing a New Swap Dealer and Intermediary Oversight Program.—Dodd-Frank creates two new categories of registrants: "swap dealer" and "major swap participant." Staff will be needed to regulate them for robust business conduct standards, record-keeping and reporting requirements, and capital and margin requirements. To effectively oversee swap dealers and major swap participants, the CFTC will create a new oversight program for these registrants.

Initial estimates are that there could be approximately 300 entities—compared to 127 Futures Commission Merchants (FCMs) that are currently registered with the CFTC (though other intermediaries are registered with the Commission, such as commodity trading advisers and commodity pool operators, the Commission only reviews FCMs due to resource constraints)—that will seek to register as swap dealers, FCMs or retail foreign exchange dealers.

Given the resource needs of the CFTC, we are working very closely with self-regulatory organizations, including the National Futures Association (NFA), to determine what duties and roles they can take on in the swaps markets. In par-

ticular, we proposed rules that swap dealers would be required to be members of the NFA. This could facilitate the NFA taking on responsibilities related to registration and examination of swaps dealers. Nevertheless, the CFTC has the ultimate statutory authority and responsibility for overseeing these markets. Therefore, it is essential that the CFTC have additional resources to reduce risk and promote transparency in the swaps markets.

The CFTC had 82 staff at the end of fiscal year 2010 responsible for overseeing intermediaries relating to pre-Dodd-Frank authorities. An additional 30 full-time equivalent (FTE) staff are requested for the new Swap Dealer and Intermediary Oversight Program for fiscal year 2012, for a total of 112 FTE. The requested FTE resources will be essential to fulfill significant responsibilities related to registrants.

Clearing of Standardized Swaps Through CFTC-registered Derivatives Clearing Organizations (DCOs).—The Dodd-Frank Act requires that standardized swaps be cleared through CFTC-registered DCOs. It also requires that the CFTC review and examine systemically important DCOs for compliance on a yearly basis, which we do not currently have the resources to do. Clearing has lowered risk in the futures marketplace since the 1890s. As of the end of the last fiscal year, the CFTC oversaw 14 DCOs. Based on information we have received from potential new clearinghouses, we anticipate a 50 percent increase in DCOs to 20 or 21. The CFTC currently has 40 FTE allocated to clearing oversight and risk surveillance. We are requesting an increase of 30 FTE during fiscal year 2012 for that team to address the significant increase in the number of DCOs, the more complex nature of the swaps markets and the Congressional mandate that we annually examine systemically important DCOs. This would bring total staffing levels to 70. The requested FTE resources will be essential to fulfill responsibilities related to clearing.

Oversight of SEFs and Designated Contract Markets (DCMs).—The CFTC will need additional staff to implement many new provisions related to the oversight of swaps trading activity as well as to oversee futures trading activities. These include procedures for the review and oversight of an entirely new regulated market category: SEFs. Staff in the Division of Market Oversight must establish and implement procedures for the review of new SEF applications and for the annual examination of the operations of SEFs, as well as any DCMs that offer swaps for trading. While the CFTC currently oversees 16 DCMs, based on industry comments, we that anticipate 30–40 entities will apply to register as SEFs.

Further, additional staff is necessary to evaluate data on swaps trading activity to implement the Dodd-Frank Act's real time reporting provisions and to establish appropriate block trade levels. At the end of fiscal year 2010, the CFTC had 40 staff responsible for our pre-Dodd-Frank responsibilities to oversee futures exchanges. The President's request would increase that level to 62 FTE while adding 38 FTE to implement new Dodd-Frank Authorities during fiscal year 2012 for a total of 100 FTE.

Market Surveillance, Position Limits, and SDRs.—The Dodd-Frank Act substantially expanded the responsibilities of the CFTC's Market Surveillance Unit in a number of critical ways. The Market Surveillance Unit currently administers a CFTC-set position limit regime for a total of nine agricultural futures contracts listed on DCMs. Under the Dodd-Frank Act, resources must be dedicated to implementing and enforcing new aggregate position limits that are required to be adopted that will cover both the futures market and some portion of the swaps market. These limits would apply to 28 agricultural, energy, and metals commodities.

The CFTC also must establish and implement new procedures and monitoring mechanisms to ensure that swaps data is appropriately reported to SDRs. Such data must be properly monitored, maintained and made available to the CFTC and other regulators. In addition, the Commission must have sufficient resources to analyze swaps data, detect and prevent market abuses and systemic problems, and to prepare semi-annual reports on the swaps markets mandated by the Dodd-Frank Act. Initial estimates are that the CFTC will receive at least five SDR applications upon the general effective date of Dodd-Frank.

The CFTC requests resources for 42 FTE to implement these new authorities during fiscal year 2012. The CFTC also is requesting 105 FTE to carry out pre-Dodd-Frank authorities in the areas of market surveillance, trade practice surveillance and data management, and analysis responsibilities. This would bring total FTE for these functions to 147 FTE.

Enhanced Enforcement Authority.—The CFTC's enforcement program is operating with approximately 167 FTE. The Dodd-Frank Act significantly enhanced

and expanded the CFTC's responsibility to police the markets for fraud, manipulation, and other abuses and will result in a substantial increase in the Commission's workload. The CFTC requires 68 additional FTE for the enforcement program in fiscal year 2012 over fiscal year 2010 levels to reach a total of 235 FTE.

Enhancing Consumer Education.—To enhance consumer protection, the CFTC will reorganize the Commission's current consumer education and protection functions into a single office. This group will focus on the design, implementation, and oversight of the CFTC's customer education and outreach program. This program will allow a significant increase in the CFTC's consumer outreach and education. In addition, we will establish a program to implement and administer the whistleblower requirements of the Dodd-Frank Act.

Enhancing Legal Analysis.—As novel and complex legal and economic issues arise in the development and application of rules to implement Dodd-Frank, the Office of General Counsel need to grow from a fiscal year 2010 level of 50 FTE to 70 FTE during fiscal year 2012. This staffing level is essential to support all of its programs.

Regulating Foreign Boards of Trade.—Currently, the Chief Counsel's Office in the CFTC's Division of Market Oversight has a single FTE dedicated to the processing of no-action requests from foreign boards of trade (FBOTs) seeking to permit direct access to their trading platforms by members based in the United States. Currently, 20 FBOTs operate in the United States based upon no-action letters dating back to 1999. We expect those 20 FBOTs to register with the CFTC, plus an additional 6 to 10 FBOTs who have recently expressed an interest in becoming registered. The Dodd-Frank Act's establishment of the new category of registered FBOTs requires an increase of two FTE dedicated to FBOT matters to raise the total to three FTE.

Ensuring U.S. Interests in the Global Marketplace.—The Office of International Affairs, which currently has 9 staff, requires 4 additional professional staff to address the increasing global reach of the futures and swaps markets for a total of 13 staff. Dodd-Frank specifically mandates that the CFTC consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation of swaps and futures. Additional staff is required to negotiate memoranda of understanding with other regulatory authorities.

Broadening Economic Analyses.—Swaps vary substantially in terms of economic structure and will require expanded economic analyses. The Office of the Chief Economist, which employed 14 FTE at the end of fiscal year 2010, requires 6 additional FTE for a total of 20 to expand the use of econometric and analytic techniques to the swaps marketplace to gauge the effects of market activities and the regulation of those activities.

CONCLUSION

Financial markets are complex, global and interconnected, and they perform essential functions for American businesses. The derivatives markets allow producers, merchants, corporations, municipalities, nonprofit organizations, pension funds, and other end-users to lower their risk by locking in prices and rates in the future. This helps promote a vibrant economy.

We recognize that the budget deficit presents significant challenges to the Congress and the American public. But we cannot forget that the 2008 financial crisis was very real. Thus the Congress responded and said that the swaps market must be regulated and overseen, significantly expanding the scope of the CFTC. It is important that we align the CFTC's funding with its expanded mission.

The CFTC looks forward to working with the Congress and the administration to address the challenges outlined here and to secure the necessary funding to strengthen market integrity, lower risk, protect investors, promote transparency, and continue to restore health to the economy.

Senator DURBIN. Thank you Chairman Gensler.
Chairman Schapiro.

SECURITIES AND EXCHANGE COMMISSION

STATEMENT OF HON. MARY L. SCHAPIRO, CHAIRMAN

Ms. SCHAPIRO. Chairman Durbin, Ranking Member Moran, and Senator Lautenberg. Thank you for the opportunity to testify in support of the President's fiscal year 2012 budget request for the SEC. And I am, of course, pleased to appear with my colleague, Chairman Gensler.

The \$1.4 billion that we are requesting will allow us to adequately staff the SEC to fulfill our core mission of protecting investors, expand our information technology systems so that we can realize operational efficiencies and better keep pace with increasingly sophisticated financial market participants, and carry out our new responsibilities over hedge funds, derivatives and credit rating agencies.

As you know, we have worked tirelessly to make the SEC a more vigilant, agile, and responsive agency over the past 2 years. And we continue moving forward on multiple fronts designed to enhance our effectiveness and ensure robust oversight of the markets.

In addition, we've embarked on a vigorous rulemaking agenda addressing critical issues, including equity market structure, money market fund resiliency, asset-backed securities, consolidated audit trail, and municipal securities disclosure. I believe we've made a number of necessary changes and accomplished a great deal.

But this year we find ourselves at a critical juncture, and that is because the Congress has challenged us not only to continue our reform efforts and to carry out our core responsibilities, but also to fulfill the significant new responsibilities given to the SEC under the Dodd-Frank Act.

As you know, separate and apart from that legislation, the SEC is responsible for essential market—financial market activities, such as pursuing fraud; reviewing public company disclosures; inspecting the activities of investment advisers, investment companies, and broker dealers; and ensuring fair and efficient markets.

Over the past decade, the size and complexity of the securities markets have grown at a rapid pace. Indeed, during the past decade trading volume more than doubled, listed equity market volume alone now averages approximately 8.5 billion shares a day, the number of investment advisers grew by 50 percent, and the assets they manage increased to \$38 trillion. Today, the SEC has responsibility for approximately 35,000 entities, including direct oversight of more than 11,000 investment advisers, 7,500 mutual funds, 5,000 broker dealers with more than 160,000 branch offices.

We also review the disclosures and financial statements of approximately 10,000 reporting companies, and we oversee transfer agents, exchanges, clearing agencies and credit rating agencies. Indeed, we oversee some financial firms that regularly spend many

times more just on their technology operations than the SEC's entire budget.

And because of the new legislation, we are taking on considerable new responsibilities for oversight of the OTC derivatives market and hedge fund advisers, registration of municipal advisers and security-based swap market participants, enhanced supervision of credit rating agencies, heightened regulation of asset-backed securities, and the creation of a new whistleblower program.

A budget of \$1.4 billion would allow us to hire the experts and acquire the technology we need to effectively carry out both our core responsibilities and to begin to implement the Dodd-Frank Act. Of the 2012 requested amount, we estimate that \$123 million will be allocated to begin implementing the provisions of the new law.

This funding request also will support information technology investments of \$78 million, including vital new technology initiatives ranging from data management and integration to internal accounting and financial reporting. It will permit the SEC to continue development of risk analysis tools to help us triage and analyze tips, complaints, and referrals. And it will permit us to complete a digital forensics lab that enforcement staff will use to recreate data from computer hard drives and cell phones, to capture evidence of sophisticated frauds.

PREPARED STATEMENTS

Finally, it is important to note that under the Dodd-Frank Act the SEC's fiscal year 2012 funding request will be fully offset by matching collections of fees on securities transactions. Beginning with 2012, the SEC is required to adjust its fee rates so the amount collected will match the total amount appropriated for the SEC by the Congress. Because of this mechanism, the SEC funding will be deficit neutral.

I thank the subcommittee for your support, and I look forward to working with you to improve the SEC's performance of its core mission, to implement our new responsibilities, and to continue protecting investors. And I am, of course, happy to answer any questions that you have.

[The statements follow:]

PREPARED STATEMENT OF MARY L. SCHAPIRO

Chairman Durbin, Ranking Member Moran, members of the subcommittee: Thank you for the opportunity to testify in support of the President's fiscal year 2012 budget request for the Securities and Exchange Commission (SEC).¹ I welcome this opportunity to answer your questions and provide you with additional information on how the SEC would make effective use of the \$1.407 billion that is requested for the coming fiscal year.²

Over the past 2 years, we have worked tirelessly to make the SEC more vigilant, agile, and responsive, and are moving on multiple fronts to enhance the Commission's effectiveness and provide robust oversight of the financial markets. We have new senior leadership in all key positions and have embarked on a vigorous rule-making agenda, addressing areas such as equity market structure, investment ad-

¹A copy of the SEC's FY2012 Budget Congressional Justification can be found on our Web site at <http://www.sec.gov/about/secfy12congbudgetjust.pdf>.

²The views expressed in this testimony are those of the Chairman of the Securities and Exchange Commission and do not necessarily represent the views of the President or the full Commission.

viser custody controls, money market fund resiliency, asset-backed securities, large trader reporting, pay-to-play, and municipal securities disclosure.

In addition to carrying out our longstanding core responsibilities, last year's enactment of the Dodd-Frank Act has added significantly to the SEC's workload. In the short term, it requires the SEC to promulgate more than 100 new rules, create five new offices, and produce more than 20 studies and reports. The law assigns the SEC considerable new responsibilities that will have a significant long-term impact on the Commission's workload, including oversight of the over-the-counter (OTC) derivatives market and hedge fund advisers; registration of municipal advisers and security-based swap market participants; enhanced supervision of nationally recognized statistical rating organizations (NRSROs) and clearing agencies; heightened regulation of asset-backed securities (ABS); and creation of a new whistleblower program.

My testimony will provide an overview of the SEC's actions and initiatives during the past year. I will then discuss the fiscal year 2012 budget request and the activities that these resources would make possible.

NEW LEADERSHIP, ORGANIZATIONAL REFORM, AND EXPERTISE

Without a doubt, the most critical element to our success in improving the SEC's operations is the Commission's talented staff. Over the past 2 years, we have installed new management across the major divisions and offices of the SEC. These new senior managers are playing a vital role in our efforts to transform the Commission.

During my first year, we brought in new leadership to run the four largest operating units—the Division of Enforcement, the Office of Compliance Inspections and Examinations (OCIE), the Division of Corporation Finance, and the Division of Trading and Markets. We also created a new Division of Risk, Strategy, and Financial Innovation to re-focus the SEC's attention on—and response to—new products, trading practices, and risks.

This past year, we brought on board a new director to oversee the Division of Investment Management, and hired deputy directors in the Divisions of Trading and Markets and Corporation Finance. We also brought on board key leaders to help improve internal operations. This includes the creation of a new Chief Operating Officer position; the hiring of a new Chief Financial Officer to oversee the SEC's budget, accounting, and financial reporting; the hiring of a new Chief Information Officer to oversee the SEC's information technology program; and the hiring of the SEC's first Chief Compliance Officer. At all levels we have focused on hiring individuals with key skill sets that reflect the rapidly changing markets under our supervision.

We're continuing to make significant progress in reforming how the SEC operates. Since 2009, the SEC has carried out a comprehensive review and restructuring of its two largest programs—enforcement and examinations—to ensure effective performance. The Enforcement Division has streamlined its procedures to bring cases more swiftly, removed a layer of management, created national specialized units, and added new staff with new skills to pursue complex fraud and market abuses. The SEC's examinations unit restructured its exam program after a top-to-bottom review, becoming more risk-based in its approach, enhancing staff training, and installing better systems to support examiners. And more recently, we have begun analyzing and implementing recommendations from the Boston Consulting Group, Inc., which the SEC retained to perform an independent organizational assessment pursuant to section 967 of the Dodd-Frank Act.

Also during the past year, to the extent permitted by available resources, we worked to improve training and education of SEC staff, to establish a deeper reservoir of experts throughout the SEC, and to modernize information technology, including a centralized system for tips and complaints, enforcement and examination management systems, risk analysis tools, and financial management systems.

ENFORCING THE LAW

Enforcement of the securities laws is the foundation of the SEC's mission. Swift and vigorous proceedings directed at those who have broken the law are at the heart of the SEC's efforts to protect investors.

In the past year, the SEC has continued our structural reforms of the enforcement program. We have created five national specialized investigative groups dedicated to high-priority areas of enforcement; adopted a flatter organizational structure to permit more staff to be allocated to front-line investigations; and created a new Office of Market Intelligence (OMI) to serve as the hub for the effective handling of tips, complaints, and referrals.

The Dodd-Frank Act substantially expands the SEC's authority to compensate whistleblowers who provide the Commission with high-quality information about violations of the Federal securities laws. Last November, the SEC proposed rules mapping out the procedure for would-be whistleblowers to provide information to the Commission. The proposed rules describe how eligible whistleblowers can qualify for an award through a transparent process that provides them an opportunity to assert their claim to an award. Pending the adoption of final rules, enforcement staff has been reviewing and tracking whistleblower complaints submitted to the SEC.

We also have added a series of additional measures to encourage corporate insiders and others to come forward with evidence of wrongdoing. These new cooperation initiatives establish incentives for individuals and companies to fully and truthfully cooperate and assist with SEC investigations and enforcement actions. This program will encourage "insiders" with knowledge of wrongdoing to come forward early, thus allowing us to shut down fraudulent schemes earlier than would otherwise be possible.

These reforms, which were intended to maximize our use of resources and permit the SEC to move more swiftly and strategically, are already showing improvements. Over the past calendar year, court-ordered disgorgements are up 20 percent, while the amount of monetary penalties has almost tripled. Of course, numbers alone don't fully capture the complexity, range, or importance of our enforcement accomplishments. During the past year, the SEC:

- Brought significant actions involving issues arising from the financial crisis, including actions against the former Chief Executive Officer and other executives of Countrywide Financial; Citigroup and its former Chief Financial Officer and Head of Investor Relations, Morgan Keegan; Goldman Sachs; State Street Bank; former executives of New Century Financial and IndyMac Bancorp; Brookstreet Securities; and ICP Asset Management and its president;
- Obtained multi-million dollar settlements with Tyson Foods, Alcatel-Lucent, Technip, General Electric, and Johnson & Johnson for violations of the Foreign Corrupt Practices Act;
- Filed our first case against a State involving municipal securities;
- Brought accounting fraud cases against Dell, Diebold, DHB Industries, and Satyam Computer Services;
- Charged a corporate attorney and Wall Street trader with insider trading in advance of at least 11 merger and acquisition announcements involving clients of the law firm where the attorney worked;
- Charged a Food and Drug Administration (FDA) chemist with trading on confidential information about upcoming announcements of FDA drug approval decisions;
- Brought a significant case alleging inappropriate use of confidential customer information by a proprietary trading desk at Merrill Lynch and an action against AXA Rosenberg in the challenging and rapidly evolving area of computer-based quantitative investment management;
- Filed a variety of cases to halt Ponzi scheme operators and perpetrators of offering frauds, including those brought in conjunction with the Financial Fraud Enforcement Task Force's Operation Broken Trust sweep—indeed, in each of the past 2 fiscal years we have filed more than twice as many Ponzi cases as we filed in fiscal 2008;
- Brought actions alleging illegal trading on confidential information obtained from technology company employees moonlighting as expert network consultants and illegal trading by major hedge funds based on illegal tips; and
- Brought an action alleging a \$1.5 billion mortgage securities fraud scheme to defraud the U.S. Treasury's Troubled Asset Relief Program.

STRENGTHENING OVERSIGHT

Strong regulation is essential to the fair, orderly, and efficient operation of markets. A vigorous examination program not only reduces the opportunities for wrongdoing and fraud, but also provides early warning about emerging trends and potential weaknesses in compliance programs.

This past year, the SEC reorganized the Commission's national examination program in response to rapidly changing Wall Street practices and lessons learned from the Madoff and Stanford frauds. The SEC strengthened the national exam program to provide greater consistency and efficiencies across our 11 regions and to focus more sharply on identifying the higher-risk firms that it targets for examination. We also implemented new policies requiring examiners to routinely verify the existence of client assets with third-party custodians, counterparties, and customers. Ad-

ditionally, the exam unit now assembles individual specialists with the appropriate skill-sets for the firm they are examining or the issues on which they are focusing. Finally, the SEC has also worked to enhance the training of examiners and bring on board specialists in risk management, trading, and complex structured products.

These reforms are helping to deliver results in the exam program's work to evaluate risks, inform policy, and identify potential wrongdoing. In fact, in January 2011 alone, the Enforcement Division brought three significant cases stemming directly from exams. And going forward, the national exam program will continue to conduct sweeps in critical areas from trading practices to market manipulation to structured products.

IMPROVING MARKET STRUCTURE

No discussion of the SEC's actions over the past year would be complete without a discussion of May 6, 2010—the day our markets dropped more than 500 points in a matter of minutes, only to bounce back minutes later. That event reinforced the importance of our ongoing review of market structure, which we had launched months earlier with a concept release inviting comment on regulation of the changing financial markets.

The U.S. equity market structure has changed dramatically in recent years. A decade ago, most of the volume in stocks was executed manually, whether on the floor of an exchange or over the telephone between traders. Now nearly all orders are executed by fully automated systems at great speed. The fastest exchanges and trading venues are now able to accept, execute, and send a response to orders in less than one-thousandth of a second.

Speed is not the only thing that has changed. As little as 5 years ago, the great majority of U.S. equities capitalization was traded on a listing market—the New York Stock Exchange (NYSE)—that executed nearly 80 percent or more of volume in those stocks. Today, the NYSE executes approximately 22 percent of the volume in its listed stocks. The remaining volume is split among 15 public exchanges, more than 30 dark pools, 3 electronic communication networks, and more than 200 internalizing broker-dealers. Currently, more than 30 percent of the volume in U.S.-listed equities is executed in venues that do not display their liquidity or make it generally available to the public, reflecting an increase over the last year.

The evolution of trading technologies has dramatically increased the speed, capacity, and sophistication of the trading functions that are available to market participants. The new electronic market structure has opened the door for entirely new types of professional market participants. Today, proprietary trading firms play a dominant role by providing liquidity through the use of highly sophisticated trading systems capable of submitting many thousands of orders in a single second. These high-frequency trading firms can generate more than 1 million trades in a single day and now account for more than 50 percent of equity market volume.

Over the past year, the SEC has engaged in a dedicated effort to study and learn from the experiences of May 6, with the aim of taking action to preserve the benefits of the current structure while minimizing its downsides. The SEC worked with Financial Industry Regulatory Authority (FINRA) and the exchanges to develop rules that trigger circuit breakers for certain individual stocks, clarify up front how and when erroneous trades would be broken, and effectively prohibit “stub quotes” in the U.S. equity markets. We adopted a rule that prohibits broker-dealers from providing their clients with unfiltered access to exchanges, and proposed the creation of a large trader reporting system that would enhance our ability to identify large market participants, collect information on their trades, and analyze their trading activity.

We also proposed a new rule that would require the creation of a consolidated audit trail that would enable regulators to track information about trading orders received and executed across the securities markets. Today, there is no standardized, automated system to collect data across the various trading venues, products, and market participants. Each market has its own individual and often incomplete data collection system, and as a result, regulators tracking suspicious activity or reconstructing an unusual event must obtain and merge an immense volume of disparate data from a number of different markets. And even then, the data does not always reveal who traded which security, and when. To obtain individual trader information, the SEC must make a series of manual requests that can take days or even weeks to fulfill. In brief, the SEC's tools for collecting data and surveilling our markets are wholly inadequate to the task of overseeing the largest equity markets in the world.

KEY RULEMAKING

Over the past year, the SEC has pursued an active rulemaking agenda aimed at making our financial markets more secure, providing investors with more and better information, finding ways to make securities markets less volatile and more transparent, and promoting effective corporate governance. Even before passage of the Dodd-Frank Act, the SEC was in the midst of a productive period of rulemaking on diverse topics. Among the key ongoing and recently completed rulemakings are the following:

Municipal Securities.—The SEC adopted rules that provide market participants with more meaningful and timely information regarding the health of municipal securities. In addition, as discussed below, we adopted rules to curtail pay-to-play practices by investment advisers seeking to manage public pensions.

Proxy Enhancements.—The SEC adopted rules to facilitate exercise of shareholders' traditional State law right to nominate directors to corporate boards. We also improved disclosure relating to risk and compensation and revised the e-proxy rules so that additional materials could be provided to shareholders with the company's notice. And, we issued a concept release requesting public input on the mechanics of proxy voting and shareholder communications.

Investment Adviser Disclosure.—In order to ensure that investors receive clear and accurate information from their advisers, the SEC adopted rules requiring advisers to provide clients with brochures that plainly disclose their business practices, fees, conflicts of interests, and disciplinary information.

Mutual Funds Fees and Marketing.—The SEC proposed rules to create a more equitable framework for mutual fund marketing fees, known as 12b-1 fees. We proposed rules to help clarify the meaning of a date in a target date fund's name, as well as enhance information in fund advertising and marketing materials.

Target Date Funds.—The SEC proposed rules that are intended to provide enhanced information to investors concerning target date retirement funds and reduce the potential for investors to be confused or misled regarding these funds.

Money Market Funds.—The SEC took action to permit investors, for the first time, to access detailed information that money market funds now file with the Commission, including their "shadow NAV" (net asset value). While the SEC uses this information in its real-time oversight of money market funds, public disclosure can provide investors and market analysts with useful insight for their evaluation of funds. We also tightened the quality standards that apply to the funds' investments and are working with our regulatory colleagues to assess the various options for making sure these funds are as safe and resilient in the face of market stresses as investors are led to believe.

Asset-backed Securities.—The SEC proposed rules that would revise the disclosure, reporting and offering process for ABS to better protect investors in the securitization market.

Market Access.—The SEC took an important step to promote market stability by adopting a new market access rule. Broker-dealers that access the markets themselves or offer market access to customers will be required to put in place appropriate pre-trade risk management controls and supervisory procedures. The rule effectively prohibits broker-dealers from providing customers with "unfiltered" access to an exchange or alternative trading system. The rule should prevent broker-dealers from engaging in practices that threaten the financial condition of other market participants and clearing organizations, as well as the integrity of trading on the securities markets.

Pay-to-Play.—The SEC adopted in June of last year a new rule to address so-called "pay-to-play" practices in which investment advisers make campaign contributions to elected officials in order to influence the award of contracts to manage public pension plan assets and other government investment accounts. The rule, adopted in response to a growing number of reports of such activities across the country, is intended to combat pay-to-play arrangements at the State and local government level in which advisers are chosen based on their campaign contributions to political officials rather than on merit.

In addition to these items, enactment of the Dodd-Frank Act added significant new work to the SEC's agenda, including more than 100 rulemaking provisions applicable to the SEC. To date, the SEC has issued 34 proposed rule releases, 7 final rule releases, and 2 interim final rule releases in connection with the Dodd-Frank Act. We have received thousands of public comments, held hundreds of meetings with market participants, completed seven studies, and hosted five roundtables. Key rulemakings under the Dodd-Frank Act include regulations for the supervision of OTC derivatives, private fund advisers, asset-backed securities, credit rating agen-

cies, corporate governance, rewards for whistleblowers, and specialized disclosure provisions related to conflict minerals, mine safety, and resource extraction.

SEC RESOURCES

This year finds the SEC at an especially critical juncture in its history. Not only does the Dodd-Frank Act create significant additional work for the SEC, both in the short and long term, but the Commission must also continue to carry out its longstanding core responsibilities. These responsibilities—pursuing securities fraud, reviewing public company disclosures and financial statements, inspecting the activities of investment advisers and broker-dealers, and ensuring fair and efficient markets—remain essential to investor confidence and trust in financial institutions and markets.

Over the past decade, the SEC has faced significant challenges in maintaining a staffing level and budget sufficient to carry out its core mission. The SEC experienced 3 years of frozen or reduced budgets from fiscal year 2005 to 2007 that forced a reduction of 10 percent of the Commission's staff. Similarly, the SEC's investments in new or enhanced information technology (IT) systems declined about 50 percent from fiscal year 2005 to 2009.

As a result of increased funding levels in fiscal year 2009 and fiscal year 2010, current SEC staffing levels have only recently returned to the level of fiscal year 2005, despite the enormous growth in the size and complexity of the securities markets since then. During the past decade, for example, trading volume has more than doubled, the number of investment advisers has grown by 50 percent, and the assets they manage have increased to \$38 trillion. Six years ago, the SEC's funding was sufficient to provide 19 examiners for each \$1 trillion in investment adviser assets under management. Today, that figure stands at 12 examiners per \$1 trillion. A number of financial firms spend many times more each year on their technology budgets alone than the SEC spends on all of its operations.

Today, the SEC has responsibility for approximately 35,000 entities, including direct oversight of 11,800 investment advisers, 7,500 mutual funds, and more than 5,000 broker-dealers with more than 160,000 branch offices. We also review the disclosures and financial statements of approximately 10,000 reporting companies. The SEC also oversees approximately 500 transfer agents, 15 national securities exchanges, 9 clearing agencies, 10 NRSROs, as well as the Public Company Accounting Oversight Board, FINRA, Municipal Securities Rulemaking Board, and the Securities Investor Protection Corporation.

In addition to our traditional market oversight and investor protection responsibilities, the enactment of the Dodd-Frank Act has added significant new responsibilities to the SEC's workload. These new responsibilities include a parallel set of responsibilities to oversee the OTC derivatives market, including direct regulation of participants such as security-based swaps dealers, venues such as swap execution facilities, warehouses such as swap data repositories, and clearing agencies set up as long-term central counterparties. In a similar fashion, under the Dodd-Frank Act the SEC has been given responsibilities for hedge fund advisers that are similar to those that the Commission has long overseen with respect to traditional asset managers. These hedge fund advisers include those that trade with highly complex instruments and strategies. Additionally, the SEC has new responsibility for registration of municipal advisers, enhanced supervision of NRSROs, heightened regulation of asset-backed securities, and the creation of a new whistleblower program.

FISCAL YEAR 2011 BUDGET

Under the agreement that was recently approved by the Congress and signed by the President, the SEC's fiscal year 2011 appropriation is \$1.185 billion, an increase of \$74 million more than the fiscal year 2010 enacted level. While the SEC is still working to finalize an operating budget for the balance of the year that will make effective use of these funds, I want to provide you with some insight into some of the Commission's priorities for the remainder of fiscal year 2011. Specifically, the fiscal year 2011 funding level provided by the Congress will allow the SEC to fill vacancies to meet key strategic needs, perform tasks required by the Dodd-Frank Act, and continue to improve Commission operations.

It will permit us to address important staffing needs, particularly within the Division of Trading and Markets, Division of Enforcement, and OCIE, which will permit us to partially address the SEC's significant staffing capacity gap. These needs include revitalizing core programs such as enforcement and inspections activities, as well as addressing new responsibilities such as enhancing oversight of credit rating agencies and adding staff with expertise in critical areas such as derivatives.

Additionally in the last 5 months of fiscal year 2011, we plan to make needed investments in the development, modernization, and enhancement of information technology that can lead to additional savings or aid staff productivity. We will be making key investments in general IT infrastructure modernization, including refreshing old technology and system hardware and software to avoid loss of productivity, facilitating the migration of the SEC's financial systems to a shared service provider, increasing system capacities to accommodate data growth, and increasing operational efficiencies through better monitoring of system performance. We will also continue making needed investments in systems and technologies needed to facilitate reporting of information required by the Dodd-Frank Act.

Finally, in fiscal year 2011 we will also continue to advance the SEC's efforts to improve Commission operations. I have recently submitted a reprogramming request to improve efficiency by consolidating the functions of the Office of the Executive Director into the Office of the Chief Operating Officer. Also in fiscal year 2011, we expect to undertake major reforms in the Office of Information Technology and Office of Human Resources, which provide critical back-office support to all SEC divisions and offices. The SEC also plans significant investment in the current fiscal year to respond to the recommendations made by the BCG as part of its recent independent assessment of SEC operations and organizational structure.

FISCAL YEAR 2012 REQUEST

The SEC is requesting \$1.407 billion for fiscal year 2012, an increase of \$222 million more than the new fiscal year 2011 appropriation level. If enacted, this request would permit us to add about 780 positions by the end of fiscal year 2012 for both improvements to base operations and implementation of the SEC's new responsibilities.

It is important to note that the SEC's fiscal year 2012 funding request would be fully offset by matching collections of fees on securities transactions. Currently, the transaction fees collected by the SEC are approximately 2 cents per \$1,000 of transactions. Under the Dodd-Frank Act, beginning with fiscal year 2012, the SEC is required to adjust fee rates so that the amount collected will match the total amount appropriated for the Commission by the Congress. Under this mechanism, SEC funding will be deficit-neutral, as any increase or decrease in the Commission's budget would result in a corresponding rise or fall in offsetting fee collections.

The fiscal year 2012 request is designed to provide the SEC with the resources required to achieve several high-priority goals: to adequately staff the Commission to fulfill its core mission; to continue to implement the requirements of the Dodd-Frank Act; and to expand the Commission's IT systems and management infrastructure to serve the needs of a more modern and complex organization. For purposes of my testimony today, I would like to summarize the request in each of these priority areas:

Reinvigorating Core SEC Programs.—Forty percent (312) of the new positions would be used to strengthen and support core SEC operations, including protecting investors, maintaining orderly and efficient markets, and facilitating capital formation. As mentioned before, SEC staffing levels are just now returning to fiscal year 2005 levels, even as the Commission's responsibilities have grown along with the size and complexity of the securities markets. To help restore core capabilities, this budget request would permit us to add 49 positions to the enforcement program that would grow the 5 new specialized investigative units, bolster the agency's litigation program, and expand the new OMI which conducts risk assessment and handles thousands of tips, complaints, and referrals. In our examination program, this request would allow us to add 55 personnel to augment risk assessment, monitoring, and surveillance functions and to conduct additional adviser and fund inspections. The request would also permit 37 staff to be added to the Division of Corporation Finance primarily to conduct more frequent disclosure reviews of the largest companies, 15 additional staff to the Division of Investment Management primarily to enhance oversight of money market funds and specialized products, and 11 new positions to be added to the Division of Risk, Strategy, and Financial Innovation to better equip the SEC to identify and address emerging risks and long-term issues of critical importance.

Implementing the Dodd-Frank Act.—Sixty percent (468 positions) of the new positions would be used to implement the Dodd-Frank Act. Many of these new positions would be used to hire experts in derivatives, hedge funds, data analytics, credit ratings, and other new or expanded responsibility areas, so that the SEC may acquire the deeper expertise and knowledge needed to perform effective oversight. These new positions would support 157 new positions focused

on the derivatives markets; 102 focused on hedge fund advisers; 43 to expand investigations of tips received from whistleblowers; 35 focused on municipal securities and examinations of newly registered municipal advisers; 33 focused on clearing agencies, including annual reviews of those determined to be systemically important; and 26 focused on NSRSOs principally to perform the annual examinations required by the act. Also in fiscal year 2012, the SEC would invest in technology to facilitate the registration of additional entities and capture and analyze data on the new markets.

The total fiscal year 2012 costs to implement the Dodd-Frank Act through these new positions and technology investments will be approximately \$123 million. In addition to the new positions requested in fiscal year 2012, we also anticipate that about 300 additional positions and additional technology investments will be required in fiscal year 2013 for full implementation of the Dodd-Frank Act.

Investing in Information Technology.—The SEC’s budget request for fiscal year 2012 will support information technology investments of \$78 million. This level of funding would support vital new technology initiatives including data management and integration, document management, EDGAR modernization, market data, internal accounting and financial reporting, infrastructure functions, and improved project management. This funding will permit the SEC to develop risk analysis tools to assist with triage and analysis of tips, complaints, and referrals and to complete a digital forensics lab that enforcement staff can use to recreate data from computer hard drives and cell phones to capture evidence of sophisticated frauds. The budget request would also permit the hiring of additional staff in the Office of Information Technology, including experienced business analysts and certified project managers to oversee IT projects and staff to address financial statement and information technology deficiencies identified by the Government Accountability Office (GAO).

Improving the SEC’s Management Infrastructure.—The SEC’s fiscal year 2012 request would permit the Commission to make further improvements to the Commission’s basic internal operations and to bring administrative and support services capabilities into alignment with the requirements of today’s SEC, and ensure that the Commission manages its resources wisely and efficiently. The budget request would permit the strengthening of the newly established Office of the Chief Operating Officer, including the development of a more robust operational risk management program and the build-out of a data management program. The budget request also contemplates an appropriate expansion of the SEC’s administrative support functions, including the Offices of Financial Management, human resources, administrative services, and Freedom of Information Act and records management. The request also includes the necessary space rent and other noncompensation expenses necessary to support the level of staffing requested for fiscal year 2012. Additionally, the SEC is devoting significant management attention to improving program and management controls, including in response to audits and assessments by the Office of the Inspector General, the GAO, and management’s own internal assessments.

Addressing Material Weaknesses in Internal Controls.—In November 2010, the SEC completed its Performance and Accountability Report, the equivalent of a company’s annual report. A GAO audit found that the financial statements and notes included in the report were presented fairly and in conformity with U.S. GAAP. It also, however, identified two material weaknesses in internal controls over financial reporting: one in information systems, and a second in financial reporting and accounting processes. The root causes of these weaknesses are gaps in the security and functionality of the SEC’s financial system, resulting from years of underinvesting in financial system technologies.

These material weaknesses are unacceptable. Rather than try and solve each particular deficiency in piecemeal fashion, the SEC has committed to investing the time and resources to implement a long-term, comprehensive solution. To avoid the development risks of creating new technology and systems, the SEC is switching to a Shared Service Provider approach, migrating the Commission’s financial system to the Department of Transportation (DOT). Other agencies, including the GAO, have migrated to DOT, and they have had very positive results, with clean audits free of material weaknesses. This will be a significant undertaking, which, assuming adequate funding, will culminate in the cutover to the new system in April 2012.

CONCLUSION

Thank you, again, for your support for the SEC's mission, and for allowing me to be here today to present the President's budget request. I am happy to answer any questions that you might have.

PREPARED STATEMENT OF COLLEEN M. KELLEY, PRESIDENT, NATIONAL TREASURY
EMPLOYEES UNION

For a decade now, the National Treasury Employees Union (NTEU) has represented the men and women who work at the Securities and Exchange Commission (SEC). When the NTEU first began to represent the employees, we were able to help make great strides forward in improving the efficiency and effectiveness of the agency. The NTEU supported Investors and Capital Markets Relief Act gave the SEC the authority to develop a personnel system best suited to the Commission's needs and curtailed the staff turnover crisis that vexed the Commission. Employee morale and retention improved dramatically.

However, starting in fiscal year 2005, the SEC began to take a wrong turn. It suffered through 3 years of frozen or reduced budgets resulting in a 10 percent reduction in staff as well as a failure to fully fund merit pay and retirement benefits which both labor and management agreed were needed to attract a workforce with the desired skills and experience. Some employees wondered if the leadership really supported strong and meaningful action against those who would engage in fraud and deception toward consumers and investors.

Under Chairman Mary L. Shapiro, we believe there is a renewed commitment to rigorous protection of consumers. This protection is also enhanced by the Dodd-Frank Wall Street Reform and Consumer Protection Act which will help give the SEC the resources, tools, and authority it needs so that the staff can effectively protect investors. The NTEU had strongly supported passage of this legislation. We are also pleased that recent funding improvements at the SEC have now restored staffing to the 2005 levels.

However, the job is far from done. During the recent period of almost flat funding for the SEC, trading volume more than doubled. Since 2003, the number of investment advisers has grown by roughly 50 percent, as have the number of funds they manage. A \$33 trillion industry of 35,000 separate entities is policed for fraud and illegal activities by a mere 3,800 employees of the SEC.

With insufficient funding for even its historic duties, the SEC now has significant new duties under the Dodd-Frank Act. The NTEU believes that the President's request of \$1.4 billion is the minimum needed to make sure that the SEC is able to do its job effectively. We ask that the Senate fund the SEC at an amount no less than the President's request.

We understand these are difficult financial times both for the Federal Government and the American public. Therefore, several facts need to be understood. First, while the SEC is an appropriated agency, its funding is offset by fees collected from the securities industry. Because these fees offset the entire SEC budget, proper funding of the SEC does not contribute to the deficit. Second, as American families struggle in the current economic downturn, the SEC has returned billions of dollars to cheated investors. In 2010, the SEC distributed double its budget (\$2.2 billion) to these innocent victims. The Congress should not be penny wise and pound foolish when it comes to protecting the investments of American consumers, only to see the victimized lose retirement investments or like time savings.

During the difficulties in passing the fiscal year 2011 budget, the public already saw the flaws of an underfunded SEC. Operating under the fiscal restrictions of the continuing resolution, it was not possible to pursue some quality tips and investigations of potential misconduct, while other investigations were slowed down or delayed. The SEC suffered under a reduced ability to hire expert witnesses for trial and to take testimony of certain witnesses. Funding limitations lessened the number of exams that could be conducted of high-risk registrants, thus increasing the risk of undetected violations.

Rather than a hiring freeze, as was put into place at the SEC during the continuing resolution, the SEC should have funding to hire needed new personnel to implement the provisions of the Wall Street Reform and Consumer Protection Act, as well as to be able to offer a competitive compensation package which allows the SEC to retain and attract staff with skill sets vital to keeping pace with rapidly changing markets and to identify systemic risks that may be created by entities subject to the SEC regulation. The SEC must have a budget that will fully fund its merit pay program as well as agreed-upon retirement benefits.

The NTEU remains ready to work with the subcommittee and the SEC management to help meet the goals needed so employees can do their job of protecting the American consumer and investor.

RULE-WRITING TIMETABLE

Senator DURBIN. Thank you, Chairman Schapiro, and Chairman Gensler, as well.

I don't think it's any surprise that the tables have turned politically here on Capitol Hill since the passage of the Dodd-Frank Act. And with the new Republican majority in the House of Representatives and a larger Republican presence in the Senate, some of the critics of the Dodd-Frank Act and those who voted against it now are questioning not only whether it was a good decision, but whether or not it's being implemented fairly and effectively.

And they have gone so far—many of them—as to just flat out say, “We want to delay this”—for 1 year, 18 months, maybe longer. In the instance of one issue that I'm involved in—2½ years they want to put off the implementation of some of the Dodd-Frank Act provisions. So this go-slow approach is being argued and justified as necessary because the Dodd-Frank Act, in their opinion, either did the wrong thing or, whatever they did, did it too fast, and can't be implemented effectively.

Now, I take a look at some of the comments that have been made, Chairman Gensler, about this, and wonder if you would comment on whether or not the timetable in the Dodd-Frank Act for the new rules, the comment periods and the promulgation of these rules, is in fact one that you can live with, that you can produce a good work product with.

Second, I look at the report of your IG which, who said back in April, just a few weeks ago, that it was their office's feeling that you were focusing too much on the legal side of these rules and not enough on the economic or cost-benefit side of these rules. And that is a legitimate question that I think you should address as well. So could you address those two issues?

Mr. GENSLER. I thank you, Mr. Chairman.

I think that the financial crisis was very real. There are still 7 million people probably out of work because of it, and millions who have homes that are worth less than their mortgages, and pensions that aren't securing their futures. And I think part of it was the derivatives market. It's not the only reason for the crisis, but it was a key part of it. Let us not forget AIG.

In terms of our rule-writing, I think that we've been very deliberate. We've been very public. We've had, I think, close to a dozen roundtables and 14 public hearings. We had more than 700 meetings that we posted on our Web site with market participants and investors and the like, and end-users. And we have now out for comment these roughly 50 rules that will be the whole mosaic, and people will come in and give us comments on them.

In terms of the time schedule, the Congress did lay out 1 year. We'll not complete the task in 1 year. We've done the proposal phase in roughly 9 months, working closely with the SEC. I think that we'll only take up final rules as we summarize those comments, get commissioner feedback, regulatory feedback, Congres-

sional feedback. And I think it will take us well through the summer and fall to finalize the rules.

In terms of implementation, we had 2 days of public roundtables. We have a public file on how to implement and phase in the implementation. It will significantly lower the cost to the American public if we phase in the implementation. A big bang at one date doesn't work.

But I think a delay is being considered elsewhere in the Congress. A delay of the effective date to the end of 2012, I think, would be a delay that would put the American public at risk—at risk of markets that are still dark by and large, at risk of a market that's unregulated by and large. The reforms only come into being if we actually get these rules finalized.

INSPECTOR GENERAL REPORT

In terms of the IG report, we welcomed it. We seriously considered, as we moved to final rules, to incorporate recommendations that the IG has made to us. We do have a very fine Office of the Chief Economist with a staff of about 14 economists. We are wishing in this budget request to grow it to 20. But there are also a lot of economists in the rule-writing teams that aren't in the Office of Chief Economist.

COST OF UNREGULATED DERIVATIVES

Senator DURBIN. So, I agree with your premise—that the recession that we're still living through can be traced to many sources, and one of those was an unregulated derivatives market.

Can you give me any examples of what you saw in that market that showed that the lack of regulation, the lack of oversight, led to decisions which were ultimately negative for our economy, and for many families and investors?

Mr. GENSLER. Well, at the core was a lightly regulated, ineffectively regulated insurance company called AIG that had about a \$2 trillion derivatives book. And that book had a lot of product called credit default swaps. And then the American public ended up bailing out AIG with \$180 billion.

That wasn't the only piece of the crisis, because, also, derivatives make these large financial institutions very interconnected. I believe there should be a freedom to fail—that large financial institutions should be allowed to fail—but the derivatives marketplace so ties them, like in a spider's web, that it's hard for a government, whether it's the Federal Reserve or the Treasury, to allow that. And so, the solution that the Congress passed was—bring transparency to the marketplace, ensure that what can be brought to clearinghouses—a mechanism that's worked more than 100 years—is done, and also to make sure that dealers are well-capitalized and well-regulated.

Senator DURBIN. So who would benefit, if we would either repeal the Dodd-Frank Act when it came to this derivatives market, or if we would delay indefinitely the oversight and regulation which the Dodd-Frank Act calls for?

Mr. GENSLER. I think the American public would be put at great risk. I think that a \$300 trillion marketplace—\$20 for every \$1 in our economy—would still be a dark market. So I don't think many

people benefit. There may be some who would benefit and rationally would like a darker market, where they're in the financial community. But the tens of thousands of end-users of these products need to have confidence in a marketplace where they can rely on that marketplace, see the pricing in the market place. Whether it's a farmer, rancher, a corporation hedging an interest rate risk—they'll benefit from this being well-regulated.

Senator DURBIN. If I can ask you one last question more specific, and one of the criticisms is that, instead of investing in the technology which the CFTC needs, you're in fact adding employees. Would you comment on that? I know you testified that you're requesting more money for technology.

TECHNOLOGY

Mr. GENSLER. The request for 2012 is about doubling technology, and about 35 percent more staff. So, we believe technology is the only way for us to really do this. But since we're taking on a market that's about seven or eight times the size, asking for 35 percent more staff we think is relevant.

Again on technology, at \$66 million we'll be a fraction of Wall Street. It's estimated by the TABB Group, investment banks spent \$20 billion to \$25 billion per year on technology. So we're, you know, we're kind of coming with a pea shooter here, frankly, to a sophisticated market that has a lot more than pea shooters.

Senator DURBIN. When you talk in most general terms about what we're trying to achieve here with the Dodd-Frank Act, if we're going to have regulatory oversight in a market place that was clearly unregulated and led, at least partially led to the decline of the American economy and the loss of so many jobs, the way to stop that reform is to fail to fund an agency like your own, to make sure there are no cops on the beat. And I think that's a serious mistake.

I think what we've got to do is to push forward on this law, to give you the time you need to promulgate these rules, and to give you the resources to enforce them. Otherwise we invite a similar disaster to the one we went through just a few years ago in our economy.

Senator Moran.

Senator MORAN. Mr. Chairman, thank you.

First of all, I'd follow up on your question, because I wasn't certain that I understood Chairman Gensler's answer about—I guess criticism perhaps is a too strong a word, but a belief that the CFTC has focused on hiring individuals to the workforce as compared to investing in technology.

And I think what Chairman Durbin asked you to do was to explain your rationale and to respond to that criticism.

Mr. GENSLER. Well, I think we need both. I think that we can't oversee markets just with computers. You can't send a computer into a judge to plead a case. I'm not aware of any court that allows that. So we really do need humans, as well. On a market that's seven times the size of the markets we currently oversee, we need humans, as well, to answer the questions. We think there may be as many as 200 swap dealers that will look to us for regulatory guidance, interpretations, and so forth. So, in terms of staffing

we're just about back to where we were in the 1990s. We had been shrunk, actually by 23 percent. And then with this subcommittee's help, we grew back.

But on this base of about 680 people that we had at the end of 2010, we believe that to oversee the markets we need to grow at the budget request to 983. But technology is absolutely critical. And technology spending is the larger increase percentage-wise.

Senator MORAN. Mr. Chairman, you and I had a conversation in the Banking Committee about the mosaic. I think there's been a call for a road map. How do you see the difference between those two terms? Your mosaic and perhaps my, or, an industry request for a road map, so that we know what the sequencing is of the rules?

That the mosaic, as I understand the word, would be a set of puzzle pieces that, we're not certain how they all fit together, as compared to, this is the sequence in which we will implement rules under the Dodd-Frank Act at the CFTC.

PHASE IN

Mr. GENSLER. I think they're both important. We've now substantially completed the proposal phase, though we have to address ourselves to the Volcker Rule. What we've asked is the public to give us comments on how to implement the, or phase, the effective dates. And we put out last Friday—and I'm glad to meet with you and go through it—the staff put out 13 concepts in a 4-page document as to how to phase in the implementation. Some people might call it a road map. Some might not.

But those concepts, for instance, say that the clearinghouses, the execution platforms, the dealers have to be open for business, so to speak, have their rulebooks in place at a certain time. The first, the most important thing is that they are compliant with the Dodd-Frank Act and they're open for business. And then market participants would be phased later, like a clearing mandate, later. And we actually laid out in this concept piece how to bucket that into sort of three or four different buckets and how to phase that.

But we're hoping to get more public comment. We have a public comment file through June 10 on this. And then based upon that, the CFTC, working with the SEC, would think about how to phase the implementation, which I think will go well into 2012, the phasing of this.

Senator MORAN. Does the concept that you're talking about speak to each individual rule as to what the sequence is for its implementation, or just within that rule the phase in of that rule?

Mr. GENSLER. The concepts take the entire rule set. So, it speaks to some of them individually, but it was trying to give the public a sense for the entire rule set, so that clearinghouses, execution facilities, and dealers would have to be, sort of, open for business. The concept even said, if we finish for rules, they have to be open for business by December 31 of this year, for instance. But then the transaction compliance would follow later. It laid out six different chapter headings with regard to that. So it was, it wasn't all the way into the granular level, but it was pretty detailed.

Senator MORAN. Would there be information in that concept that would be valuable to us as a subcommittee to determine priorities

in funding, so that we could make decisions about the level of funding necessary to implement this series of rules over the period of time that you're contemplating?

Mr. GENSLER. I think it would be helpful to have that dialogue, though I would say our request is anticipating that we would complete our rules during the course of the calendar 2011 and that we'd be able to be hiring people to actually oversee these markets over fiscal 2012.

There's a commitment that our President made back in September 2009—the G20 commitment—that all of this would be completed and implemented by the end of 2012. We think the Congress, when they said to finish the rules by July 2011, had in mind that this was a very real crisis, and second, that the market needs to lower uncertainty. Our rule-writing creates some uncertainty. To the extent we can finish that, it helps lower uncertainty, and people get on with their work to implement it.

Senator MORAN. Chairman, I appreciate that statement. I think that has great significance. I think one of the real challenges we have for economic recovery is all the uncertainty that's out there in regard to new rules and regulations. And certainty would be a good thing, although we need to make certain that we're doing it in the appropriate manner. So, I share that, in my view there's a balance between getting an answer to the industry, but also making sure it's the right answer.

Finally, let me ask about position limits and core principles. It's a conversation that we've had at every opportunity, both in my days in the House and on the Banking Committee, and now here in the Appropriations Subcommittee. Those are not required rules and regulations. Is there a different priority placed at the CFTC on rulemaking that is not mandatory but discretionary?

POSITION LIMITS AND CORE PRINCIPLES

Mr. GENSLER. What we're doing is trying to bring together the whole package. On position limits, the Congress says specifically that we shall. The word S-H-A-L-L, shall, is in there. Some of the comment letters have come back in and people debate what was the Congress's intent. But there were numerous Congressional hearings. So we put out a proposed rule on position limits, we believe, following Congressional mandate.

In terms of core principles for clearinghouses and for exchanges, we think that we really need to move forward on this because it's the only way that the clearinghouses will be safe. There's a mandate that hundreds of trillions of dollars of swaps have to come into these clearinghouses. And so, our rule-writing in that regard is to make sure the clearinghouses are up to international standards, and that the Europeans will recognize United States clearinghouses.

So I think that, though we can debate whether the Congress said "shall" or "may" in that regard, I think if we didn't write the rules on the clearinghouses, that we wouldn't be up to international standards.

Senator MORAN. My understanding is that the law does say "shall, as appropriate." And so the question about what's appropriate, and, as I understand the law, when you read "as appro-

priate” in context of the Commodity Exchange Authority, it requires the CFTC to make a finding that excessive speculation caused an unwarranted or unreasonable price fluctuation in particular commodity markets.

And I, we’ve had this conversation before. I keep waiting for the finding by the CFTC. You have an old staff report that somewhat addresses this issue, but I’ve yet to see the finding by the CFTC that excessive speculation was found in the markets.

Mr. GENSLER. Well, we are not a price-setting agency. But what the agency has used since the 1930s is position limits, as the Congress has mandated since the 1930s, to ensure that the markets have a diversity of actors. Basically that, bona fide hedgers don’t come under this, but speculators don’t get so concentrated.

We actually had position limits in the energy markets working with exchanges in the 1980s and 1990s. In 2001, the exchanges backed away from that to something called accountability levels, which, on a very regular basis market participants go over the accountability levels. They’re no longer stop signs. They’re not even yield signs, really. They’re just, maybe, honk if you go by it.

And so we’ve re-proposed, in essence, position limits. We’re going to hear from the public. We’ve gotten 11,000 comments on this. Of our total 16,000, this is where the largest number of comments are. And I think that’s partly because of high energy prices and high agricultural prices right now. But it’s something the public very much wants us to get right, as you do. And we’re going to sort through those 11,000 comments.

Senator MORAN. Thank you, Mr. Chairman.

Senator DURBIN. Senator Lautenberg.

Senator LAUTENBERG. Thanks, Mr. Chairman.

Again, I welcome each of you here to change the game that has been played in the past, and ultimately responsible for the financial disaster, in my view, that we’ve seen.

IMPACT OF REDUCED FUNDING

Now, Chairman Schapiro, the House recently passed a budget that would reduce funding to 2008 levels. You discuss it in your comments. That would put the SEC funding at \$0.5 billion, below the President’s request. And yet the SEC expenses, as you mentioned, fully offset by industry fees, and therefore don’t add anything to the budget deficit. If the budget was, wound up that way, with that cut to 2008 level, what, in summary, what might that do to prevent you from fully doing the job that you’re assigned to do?

Ms. SCHAPIRO. Senator, going back to the 2008 level would have a very profound impact on the agency. It would take our appropriation back to about \$906 million. And even after major cuts and factoring in attrition, we would probably have to reduce our staff by more than 740 full-time equivalents to meet the \$906 million number. And if the cuts didn’t happen until perhaps January 2012, the reduction in staff would exceed 1,000 people on a base of about 3,800. So it would be enormous.

We would have to also eliminate all of our new information technology investment, which is really critical to getting this agency in a position to do the kind of market surveillance and market monitoring that I think we should be doing.

We would do fewer examinations. We would detect fewer violations of the law. We would bring fewer enforcement cases. And our enforcement program brings lots of money back to harmed investors. Last year, we returned—on a \$1 billion budget—\$2.2 billion to harmed investors directly, as well as hundreds of millions of dollars to the United States Treasury.

We would have to suspend development of new systems, like the Tips, Complaints and Referrals system, which is allowing us to bring together the massive numbers of tips and complaints the agency receives, track those, triage them and handle them in a more professional and diligent way than has been done historically.

And then, with respect to some of our internal operations—for example, the movement of our financial management systems, which have been flawed over the last several years, to a Federal shared service provider—efforts like that would have to be put on hold.

So, I think it would have a devastating impact on the agency's ability to protect the public from financial fraud.

Senator LAUTENBERG. This, to me it looks like we might wind up back in the 2008 situation if we had to restrict ourselves to the things that you're now planning to do and improve the supervision and the reliability of the marketplace. So it, by no means, in my view, can help to cut the budget or, as I said earlier, to cut staffing when so much is needed.

MADOFF SCAM AND OTHER PONZI SCHEMES

If we look back at 2008 and even earlier, a whistleblower brought information to the SEC about the evidence, with evidence of the ultimate public swindle, the Madoff scam, stole billions of dollars from investors. And the SEC apparently did very little or almost nothing to pay attention to that opportunity, to learn and to adjust. And I wonder whether any of that was caused by a limited number of people on the staff, or a smaller agency.

Is there a view, Ms. Schapiro, about what might have put the SEC in that kind of a static position, where nothing was done?

Ms. SCHAPIRO. Senator, I think resources, perhaps, was a contributing factor. But I really can't blame the SEC's failure to catch Madoff much earlier on in his fraud and shut it down, solely on a lack of resources. There were a lot of institutional issues within the agency over a long period of time—a lack of cooperation and coordination between enforcement and examinations; a lack of expertise and understanding of the information, perhaps, that the whistleblower brought to the SEC; the lack of tools and supervision of the front-line examiners in getting the job done.

We've done, as you know, an enormous amount of work to try to ensure that we can prevent anything like that from ever happening again, including the new Tips, Complaints and Referrals system, which didn't exist then, but—

Senator LAUTENBERG. But which might—forgive me, but which, all of which can be considerably improved if we put through the budget as the President requested.

Ms. SCHAPIRO. Absolutely. Not just the technology, but also the ability to bring in people with deeper expertise; the ability to train our employees in deeper and more cutting-edge ways; our ability to

have more people bring more cases and shut down more Ponzi schemes faster. Over the last 2 years we've brought twice as many Ponzi scheme cases as we did the prior 2 years before I arrived at the agency. So resources, absolutely, would help.

But I just, I don't want to say that the Madoff failures at the SEC are solely the result of inadequate resources.

CORPORATE COMPENSATION

Senator LAUTENBERG. Yes. I note the effort that would be put forth to make sure that transparency really is there in all kinds of situations.

One of them that's disturbed me—and, again, I come with a corporate background. I spent 30 years with a giant, a company that turned out to be a giant company. And the shareholders very often are not kept up to date with what's taking place.

And one of the most significant, in my view, is the variation in the relationship between the CEO compensation and the average worker in these companies. In 1980, it was a ratio of about 40 to 1. And now we're well more than 300 at times. And the difference in wages is incredible. I mean, the CEO, if the average wage was \$40,000 in 1980, the CEO might earn, then, \$1.6 million. And now, if that same situation took place, it's well more than \$13 million. And that maladjustment, in my view—and I speak to, as a long-time executive, a long-time member of the board of directors, and still a member of the board of directors at the Columbia Business School—that one of the things that's so problematic is that our society is getting lopsided here. And any way that we can produce evidence of what's, the changes that are taking place, is incredibly valuable.

And I thank you, Mr. Chairman, and we have, I have other questions, which I'd like to submit for the record.

Senator DURBIN. Thanks, Senator Lautenberg. Of course, those questions will be submitted in writing.

GASOLINE PRICES

There are, Chairman Gensler, there are a variety of rites of spring in America—the opening of the baseball season; Seder dinners, which I shared this year with Senator Lautenberg; the Easter bunny; and an obscene run-up in gasoline prices, which seems to come about every spring. And Members of Congress—Senate and the House—get into a high state of excitement and anxiety as they hear from their constituents about what these gasoline prices are doing to families and businesses.

Now, over the years I've developed a very careful watchdog of gasoline prices—my wife. And I called her this morning, and she says, "It's up to \$4.20 a gallon in Springfield. What are you doing about it?"

And I said, "Luckily, Chairman Gensler is going to be testifying today, and I'm going to ask him a question about it."

And the question comes down to this: I understand, when we talk about the futures markets and the oil prices, that speculation is not illegal, and it serves as a necessary ingredient to add liquidity to the market. But oil prices have risen to \$113 a barrel over the last few months—a one-third increase in price, right before the

summer driving season, surprise, surprise. And unrest in the Middle East and North Africa has been blamed, though the countries involved represent a very tiny fraction of the sources of oil in America.

The President has called for this integrated look at whether or not there are problems related to speculation and fraud and the like. Your CFTC Commissioner, Bart Chilton, indicated that hedge funds and other speculators have increased their positions in energy markets by 64 percent since June 2008, to the highest level on record. When it comes to speculation, can the CFTC differentiate between normal speculation, excessive speculation, and manipulation?

Mr. GENSLER. Let me say I share with your wife's view. Last night, I filled up on Connecticut Avenue for \$84 for the tank. So I, it's on my mind, too.

We're not a price-setting agency. But, as an agency, we're to make sure that these markets, that hedgers and speculators meet in a marketplace that's transparent, it's open, it's competitive, free of manipulation and fraud, and also using position limits, that there's some diversity, a lack of concentration in these speculators. That's why I think it's so important that we continue to move forward on the rules. The Congress gave us new anti-fraud and anti-manipulation authority. We've proposed rules to implement that. We're yet to finalize the rules, but that broader authority is very important. We do use our current authority, but the broader authority is important. And——

Senator DURBIN. So, the Dodd-Frank Act gives you more tools to deal with——

Mr. GENSLER. Absolutely.

Senator DURBIN [continuing]. Market speculation and manipulation, as it relates to oil prices. And, looking at this from the other side of the coin, efforts to slow down or stop your agency's implementation of the Dodd-Frank legislation will limit the availability of those tools when it comes to things like oil prices speculation.

MARGINS

Mr. GENSLER. Mr. Chairman, that is absolutely correct.

Senator DURBIN. I'm glad you said that.

Now let me ask about margins. I understand that oil speculators provide 6 percent of the value of a futures contract up front when they buy a stock. And some have argued that increasing the margin requirement will reduce the volatility, but still allow for some speculation in the industry. What is your thought?

Mr. GENSLER. The Dodd-Frank Act also addressed margin. Our authorities are limited. They're just to set margin with regard to cleared swaps, as it relates to the safety and soundness of the clearinghouse, and for uncleared swaps, the safety and soundness of the dealers, the financial system as the dealers. And we've put proposed rules out with regard to that.

So it doesn't necessarily address Mr. Chairman's question, but the Dodd-Frank Act's pretty clear that it's about the safety and soundness of the clearinghouses or the dealers themselves when we set these margins.

Senator DURBIN. Thank you, Chairman Gensler. I have to leave and be in a meeting in the House. But Senator Lautenberg has said he'll preside through the close of questions from Senator Moran and himself.

And I thank you both for coming today. We'll submit some questions in writing for you, and I hope you get a chance to respond to them in a timely fashion.

Senator Moran.

Senator MORAN. Mr. Chairman, thank you.

I, too, will submit a number of questions in writing.

I just have one follow-up question, and then a general question for both chairpersons.

I want to go back to our position limit conversation. You said that you put the position limit rule out for comment—in my view, what you were telling me is for, to determine its appropriateness. I was suggesting that position limits are to be determined, are to be under rulemaking where appropriate. And I would just make the point that whether or not it's appropriate is a determination to be made by the economists. And this goes back to the IG report—that determination about the appropriateness should be done by economists, not by lawyers.

And to date, to my knowledge, the only report you have from economists is the 2008 staff report that found no connection between excessive speculation and unwarranted price fluctuations. So, I'd be glad to have this ongoing conversation with you in, in that regard.

SAVINGS

And then, just generally, for both of you, are there any examples of where you and your agency are finding savings—reduced spending—for purposes of helping us offset the increased costs that you're requesting?

Chairman Schapiro.

Ms. SCHAPIRO. I'd be happy to do that, yes. We have a new leadership team in our technology group and a new chief operating officer of the SEC, and one of the charges I've given them is to look for those opportunities to save—particularly when we were under the continuing resolution for such a long period of time.

And so, particularly in the technology space, we've been able to retire some old equipment and utilize more efficient, more cost-effective technologies. That's an opportunity. We are moving to more risk-based approaches with respect to our examination program, so that we are using less of a broad sweep and check the box mentality, and a more focused, deeper dive into those regulatees that might actually present the greatest risk to the investing public.

We are trying to deploy knowledge management systems and e-discovery tools that will allow us again to leverage technology, rather than necessarily having to bring on a lot of human resources to do certain functions that technology does very well.

And if I can give you one sort of quirky example, we learned that at our alternative data center, we could save \$375,000 a year on an investment of \$120,000, simply by changing our power configuration. So, it gives you a very micro idea of what we're looking at.

But we are trying to go through the SEC very carefully and look for every opportunity to find savings that we can then re-deploy to higher value uses that we think will do more to protect the investing public and to ensure that the markets are operating with efficiency.

That also includes leveraging other entities like self-regulatory organizations as we develop the consolidated audit trail. There will be costs for the SEC in that, but the great majority of the costs will be borne by the exchanges and FINRA, that will have to develop the plan for the consolidated audit trail, set up the repository for the data, and then we'll develop our own tools to access that data. We're leveraging the Public Company Accounting Oversight Board, we're leveraging private accounting firms—anywhere we can leverage third parties with rigorous oversight by the SEC, we look at those as opportunities to both do a better job, and to find some savings that we can then re-deploy.

Senator MORAN. If you can quantify that, I'd welcome the piece of paper that demonstrates those savings within the SEC.

Ms. SCHAPIRO. We'd be happy to do that.

Senator MORAN. Thank you.

[The information follows:]

COST-SAVINGS INITIATIVES

Opportunity description	Savings opportunity	Potential cost savings	Total upfront cost (spend to save) ¹
Data storage system and retirement and replacement.	Reduce data storage maintenance costs by purchasing new equipment.	\$1.4 million over 3 years	\$470,000
Server virtualization and storage ..	Eliminate number of physical servers.	\$18.6 million over 3 years	\$9,100,000
Operational monitoring and metrics management.	Eliminate 30 contractor FTEs	\$5.3 million over 6 years	\$3,900,000
Power savings at SEC alternative data center.	Eliminate dedicated power circuits through consolidation at Equinix.	\$380,000 each year after first year.	\$10,000
HQ building and 11 regional buildings facilities access control contract.	Replace contract for electronic facilities access control system and surveillance systems with less expensive contract.	\$6 million over 5 years	(²)
Delegate section 31 fee verification.	Opportunity as noted in BCG study: rather than utilizing OCIE examination resources, redirect to SROs compliance costs for ensuring SROs are paying SEC the correct amount in section 31 transaction fees.	Current process uses 10 FTE for 4 months.	(³)

¹ Cost projections are estimates and thus are subject to change.

² Not applicable.

³ To be determined.

Senator MORAN. Chairman Gensler.

Mr. GENSLER. Similar to Chair Schapiro's answer, through the continuing resolution, we did. We're only just people and technology, by and large with, of course, some real estate. So, there were a number of savings. Unfortunately, in technology we cut so much that I think that, you know, we need to really, as we earlier talked about, go the other way, to leverage technology to be more efficient.

One of the significant things we've been looking at is, what duties, can we ask the self-regulatory organization, the NFA to do, particularly in terms of registering the new swap dealers, examining the new swap dealers, and we've worked very closely with them as to how they can stand up. They're probably going to have to stand up between 100 and 200 new people to do that, rather than us doing it. But we're working very closely with them.

In terms of technology, it's really, how can we leverage off of what's in the Dodd-Frank Act and these new data repositories so that as much as possible can be picked up by the data repositories? They will charge fees for that, by the way. But it won't be through the taxpayers. And that, we then get direct data access. And we've already had our chief of technology be, in direct dialogue with each of the data repository aspirants—they're not yet registered—as to how we can link up the systems and leverage off of their data.

Senator MORAN. Well, Chairman Gensler you, too, if there's a piece of paper that you could present to me, or to the subcommittee, that outlines the cost savings that are occurring. What I'm looking for is that you would be asking for more money from us, but for these savings within your agency that you've developed for fiscal year 2012.

[The information follows:]

CHECKLIST OF COMMODITY FUTURES TRADING COMMISSION COST-CUTTING INITIATIVES

The Commodity Futures Trading Commission (CFTC) is committed to reducing its operating costs. Over the last 2 fiscal years, more than \$65 million over the next 15 years in cost reductions were achieved using proactive contracting practices. The results are presented below.

RENEGOTIATE SPACE LEASES

- The estimated negotiated savings cited below totals approximately \$48.4 million:
 - The CFTC expanded and extended its existing D.C. lease to produce an estimated saving of \$42 million over 15 years when compared to the estimated cost to relocate.
 - The CFTC expanded and extended its existing Chicago lease resulting in an estimated savings estimated of \$6.4 million over 12 years versus the estimated cost to relocate.

NEGOTIATE COST REDUCTIONS ON ACTIVE CONTRACTS

The estimated negotiated savings cited below totals approximately \$17.6 million over 5 years.

A brief summary focusing on negotiated cost savings:

IT Support Services.—Estimated savings associated with the award of five contracts totals approximately \$15 million over 5 years.

IT Hardware.—Estimated savings associated with the award of two contracts totals approximately \$700,000.

Software.—Estimated savings associated with the award of one contract totals approximately \$106,000.

HR Benefits and Support Services.—Estimated savings associated with the award of two contracts totals approximately \$1.5 million over 5 years.

RENEGOTIATE ON-LINE LEGAL RESEARCH SERVICE RATES

Negotiated rate reductions for online services in the amount of \$259,000. Future savings are expected to exceed this amount on an annual basis.

LEVERAGE NASA GOVERNMENT-WIDE ACQUISITION CONTRACT

The estimated negotiated savings cited below totals approximately \$688,000.

Administrative Support Services.—Estimated savings associated with the award of two contracts totals approximately \$400,000.

Saved \$235,000 in the purchase of routers by converting a proposed GSA schedule purchase to a competitive buy.

Saved \$53,000 in the purchase of blade servers by converting a GSA schedule purchase to a competitive buy.

CONVERT SOFTWARE LICENSES TO ENTERPRISE AGREEMENTS

Negotiated an enterprise license for law office services that saved the CFTC \$145,000 compared to the price of individual licenses.

The CFTC is committed to reducing its operating costs. Over the last 2 fiscal years CFTC estimates it saved at least \$500,000 in cost reductions were achieved by changing its operating practices.

- Reduce travel costs;
- Use more teleconferencing and web technology;
- Modernize travel policies to use restricted fares where appropriate;
- Centralize employee registration and negotiate larger discounts with conference vendors; and
- Recover State lodging taxes inadvertently paid by CFTC travelers; and
- Consolidate purchases for common goods and services;
- Implemented 4-digit dialing eliminating the long distance charges on calls made between CFTC offices;
- Put more documents online to cut back on FOIA requests; and
- Set shared printer default settings for “two-sided printing”.

Senator MORAN. I thank you for your testimony today and look forward to our ongoing conversation. Thank you.

Mr. Lautenberg.

USER FEES

Senator LAUTENBERG. Thanks.

And just a couple of things that I'd like to get answers to. Mr. Gensler, the CFTC, the only financial regulator that does not offset a portion of the cost through industry user fees. Now, if the derivatives traders don't pay fees to defray the costs of the market oversight, then the taxpayers are the ones who pay the bill. Should the traders continue to—it's always in the way—should the traders continue to get a free ride while the taxpayers foot the bill?

Mr. GENSLER. We think to fulfill our mission, we look forward to working with the Congress in any way that the Congress sees fit to help fulfill the mission and secure the funding. The President's request did put forward a concept of user fees with regard to the swaps marketplace, and if that's beneficial to this subcommittee for us to work with you on that, we'd look forward to doing that, whatever the Congress thinks is the best way to secure the funding.

Senator LAUTENBERG. What would you recommend?

Mr. GENSLER. I'd recommend that we work with you in any way that helps secure the funding.

Senator LAUTENBERG. Thank you.

Ms. Schapiro, credit rating agencies play an influential role in helping investors to make decisions. Part of the SEC's budget request is devoted to closely regulating and examining these agencies. But credit rating agencies continue to be paid by the very people whose products the agencies are evaluating.

What might the SEC do to address this, what I see as a fundamental conflict of interest?

Ms. SCHAPIRO. Senator, there is a conflict of interest there, and so the Dodd-Frank Act did a couple of things to help us address that. One is that we're required to examine credit rating agencies on an annual basis, regardless of the risk a particular agency presents. And so part of our budget request is staffing for the credit

rating agency examination team. We're also required to set up an independent office of credit rating agencies, reporting directly to me.

In addition, we have about 10 different rules that we're required to do under the Dodd-Frank Act to address conflicts of interest, governance, enhanced public disclosure about the performance of ratings, and so forth. And we're working on those rules right now.

I think to get directly to your question, though, there is a requirement for three different studies on credit rating agencies, one of which is to study the feasibility of a wholly different model for credit rating agencies when they're rating structured assets. So that there would be a model potentially where the rating agency would be assigned, by the SEC or by a self-regulatory organization, to the issuer of the structured product, rather than the issuer of the structured product picking the rating agency and perhaps creating a very real conflict of interest.

That study is not due until July 2012. But we're just about to go out with our request for comment to get that study launched. And that will, I think, give us some other ideas about alternative compensation structures that might get at this very important conflict of interest issue.

Senator LAUTENBERG [presiding]. Thank you.

In New Jersey we have a nationally known philosopher whose name is Yogi Berra. And Yogi has an expression that I think is appropriate at the moment. Because if we continue to look at the cost side without the benefit side of putting additional staff to work, of investing in additional technology, it's going to be, as Yogi would say, *déjà vu* all over again. So, I'd recommend care, thought, and investments that can really pay off handsomely for the future.

With that, I thank, in the words of our chairman, all of you who've participated in preparing for the hearing. I appreciate hearing from the top officials of these two pivotal agencies about their implementation activities and funding needs. And it's fair to say that today's discussion has provided helpful insights into these agency operations, which will be instructive as we further consider the budget proposals and develop our fiscal year 2012 bill over the coming months.

ADDITIONAL COMMITTEE QUESTIONS

The hearing record, as Senator Durbin said, will be, remain open until next Wednesday, May 11, at 12 noon for subcommittee members to submit statements and/or questions to be submitted to the witnesses for the record.

And with that, I thank Senator Moran for his contribution.

[The following questions were not asked at the hearing, but were submitted to the Department for response subsequent to the hearing:]

QUESTIONS SUBMITTED TO GARY GENSLER

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

ADAPTING OPERATIONS TO EXPANDED RESPONSIBILITIES

Question. The Commodity Futures Commission (CFTC) regulates a futures and options industry that increased from 580 million contracts in 2000 to more than 3.1

billion contracts in 2010—a change of more than 434 percent. During that same decade, customer funds held in Futures Commission Merchants accounts increased from \$56.7 billion to more than \$170.1 billion, and the value of these contracts is notionally estimated at \$40 trillion. With the Dodd-Frank Act signed into law last July, the CFTC is tasked with regulating the swaps markets with an estimated notional value of approximately \$300 trillion—roughly 7 to 8 times the size of the regulated futures markets.

How will your staffing and organization need to adapt to keep pace with this growth surge?

Answer. The CFTC must be adequately resourced to police the markets and protect the public. The CFTC is taking on a significantly expanded scope and mission. By way of analogy, it is as if the agency previously had the role to oversee the markets in the State of Louisiana and was just mandated by the Congress to extend oversight to Alabama, Kentucky, Mississippi, Missouri, Oklahoma, South Carolina, and Tennessee.

With seven times the population to police, far greater resources are needed for the public to be protected. Without sufficient funding for the agency, our Nation cannot be assured of effective enforcement of new rules in the swaps market to promote transparency, lower risk and protect against another crisis. It would hamper our ability to seek out fraud, manipulation, and other abuses at a time when commodity prices are rising and volatile.

Until the CFTC completes its rule-writing process and implements and enforces those new rules, the public remains unprotected.

Question. Does CFTC's current organizational structure allow you to meet the challenge?

Answer. The CFTC has been meeting the challenge of writing rules to implement Dodd-Frank though its existing structure supplemented by rule writing teams whose members cut across divisions. As the agency moves out of the rule-writing phase to ongoing oversight of the futures and swaps markets, some changes to the existing organizational structure will be needed to meet the need to oversee new entities such as swaps dealers and better utilize technology.

Question. Are you contemplating restructuring your operations? How? By when do you expect to realign the organization?

Answer. Yes, the agency is undertaking a staff reorganization to effectively implement the Dodd-Frank Act, oversee an increasingly electronic marketplace and manage and utilize agency resources. The agency plans to create two new groups reporting to the chairman's office: a Division of Swaps and Intermediary Oversight and an Office of Data and Technology. Some realignment will occur within existing Divisions and Offices. Further changes are noted in the attached memoranda. The CFTC is planning for the realignment to become effective October 9, 2011. Notice of this planned staff reorganization was provided to the Congress by letter on May 6, 2011, presented below.

COMMODITY FUTURES TRADING COMMISSION,
Washington, DC, May 6, 2011.

Hon. DANIEL K. INOUE,
Chairman, Senate Committee on Appropriations, Washington, DC.

Hon. THAD COCHRAN,
Vice Chairman, Senate Committee on Appropriations, Washington, DC.

Hon. HAROLD ROGERS,
Chairman, House of Representatives Committee on Appropriations, Washington, DC.

Hon. NORM DICKS
Ranking Member, House of Representatives Committee on Appropriations, Washington, DC.

DEAR SENATORS INOUE AND COCHRAN AND REPRESENTATIVES ROGERS AND DICKS: The Commodity Futures Trading Commission is undertaking a staff reorganization to effectively implement the Dodd-Frank Wall Street Reform and Consumer Protection Act, oversee an increasingly electronic marketplace, and manage and utilize agency resources. We are providing this notice pursuant to the Department of Defense and Full-Year Continuing Appropriations Act, 2011.

The enclosed document describes the details of the reorganization. Please do not hesitate to contact me if you have any questions.

Sincerely yours,

GARY GENSLER,
Chairman.

Enclosure

CFTC REORGANIZATION

AUTHORITY:

Title 5, United States Code (USC)
 Commodity Exchange Act
 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)
 CFTC FY 2011–2015 Strategic Plan
 GPRA Modernization Act of 2010 (OMB Memorandum M–11–17, April 14, 2011)

Recommended CFTC Reorganization

The Commodity Futures Trading Commission (CFTC) is undertaking reorganizing, effective October 9, 2011, to structure its stall for implementation oldie Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act); oversee an increasingly electronic marketplace; and plan for, manage and utilize agency resources. The changes are consistent with the CFTC FY 2011–2015 Strategic Plan approved February 28, 2011.

Create New Groups Reporting to the Chairman’s Office

Create a Division of Swap Dealer and Intermediary Oversight (DS10).
 Create a new Office of Data and Technology (ODT).

Realign Within Existing Divisions and Offices

Division of Market Oversight (DMO).
 Division of Clearing and Intermediary Oversight (DCIO) into the Division of Clearing and Risk (DCR).
 Office of the Executive Director (OED).

Other

Rename the Office of Equal Employment Opportunity the Office of Diversity and Inclusion.

Set up a process fir determining the organizational assignment of whistleblower and consumer outreach functions.

*Functions**Division of Swap Dealer and Intermediary Oversight (DSIO)*

With an expanded mission due to the Dodd-Frank Act mandate to regulate the swaps markets, the CFTC will take on new responsibilities, including the registration and oversight of new categories of registrants such as swap dealers and major swap participants. Staff will be needed to regulate them for robust business conduct standards, record-keeping and reporting requirements and capital and margin requirements. To effectively oversee swap dealers and major swap participants, the CFTC will create a new oversight program for these and other registrants.

The primary focus of this new Division will be to oversee the regulation of swap dealers, future commission merchants and other intermediaries to ensure they have adequate financial resources and standards of conduct. This new Division initially Will be staffed through reassignment of employees currently responsible for intermediary oversight in DCIO.

Office of Data and Technology (ODT)

Effective oversight of the highly electronic derivatives marketplace requires a technology organization at the program level directly accountable to the Chairman. Increased mission scope over a broader and more complex data-centric marketplace requires an enterprise-wide, integrated data and technology strategy. Elevating the CFTC technology program to the office level reporting directly to the Chairman recognizes its importance in achieving agency strategic and operational goals and brings focus and transparency to program priorities as addressed in the FY 2011–2015 Strategic Plan. This reprioritization of functions will align the ODT Director, as Chief Information Officer, with the CFTC division and program leadership to foster a shared strategic CFTC technology portfolio, assets and budget. The ODT will have two branches:

Data Management Branch (DMB).—This branch is crucial to effective oversight of an increasingly electronic marketplace. All CFTC mission programs are fundamentally dependent on the timely capture and management of and access to quality and meaningful data. The DMB will ensure a CFTC information architecture based on data integration, integrity and quality. Working across all divisions, DMB will establish agency-wide data needs and an effective CFTC data strategy.

Technology Services Branch (TSB).—The existing functions performed by the Office of Information and Technology Services (OITS), currently located in the

Office of the Executive Director (OED), will be reassigned to ODT to partner with DMB and the program divisions/offices to implement technology solutions within a secure and stable IT environment. The Technology Services Branch will maintain the CFTC hardware and software platforms and deliver storage, security and redundancy capacity and capabilities.

Division of Market Oversight (DMO)

With the evolution of the markets and the fundamental changes made to the U.S. financial regulatory system, including new obligations with respect to the oversight of the swaps markets, the CFTC will have increased market monitoring responsibilities over new entities, such as swap execution facilities (SEFs) and swap data repositories (SDRs). Furthermore, the Dodd-Frank Act adds to the CFTC's authorities with regard to real time reporting of swaps transactions, review of new products, aggregate position limits and appropriate block trade levels. Restructuring DMO will enable the CFTC to implement oversight requirements of these new entities and authorities to ensure that the markets operate with a robust surveillance and compliance review system.

Division of Clearing and Risk (DCR)

The Dodd-Frank Act mandates that standardized swaps be cleared through CFTC-registered derivatives clearing organizations (DCOs.) It also requires that the CFTC review and examine systemically important DCOs for compliance with CFTC regulations on a yearly basis, which the CFTC does not currently do. Based on information received from interested parties, a 50 percent increase in the number of DCOs is anticipated. The Division of Clearing and Risk will consist of staff currently assigned to DCIO. It will conduct risk surveillance and examination of DCOs for swaps and futures as well as assess compliance with statutory Core Principles. In addition, it will create an organizational focus on the review and assessment of over-the-counter swaps and other derivatives instruments to determine their suitability for clearing.

Office of the Executive Director (OED)

OED reorganization will facilitate improved agency management and rationalize the structure of new functions that it absorbs, including planning, business management, physical security, Privacy Act compliance, intranet content management and the Office of the Secretariat. Changes also will accommodate increased compliance standards, including records management, personnel security and contingency planning, as well as the transfer of the technology program. This includes standardizing and formalizing business processes and decision-making to support the operational and management activities of the Commission.

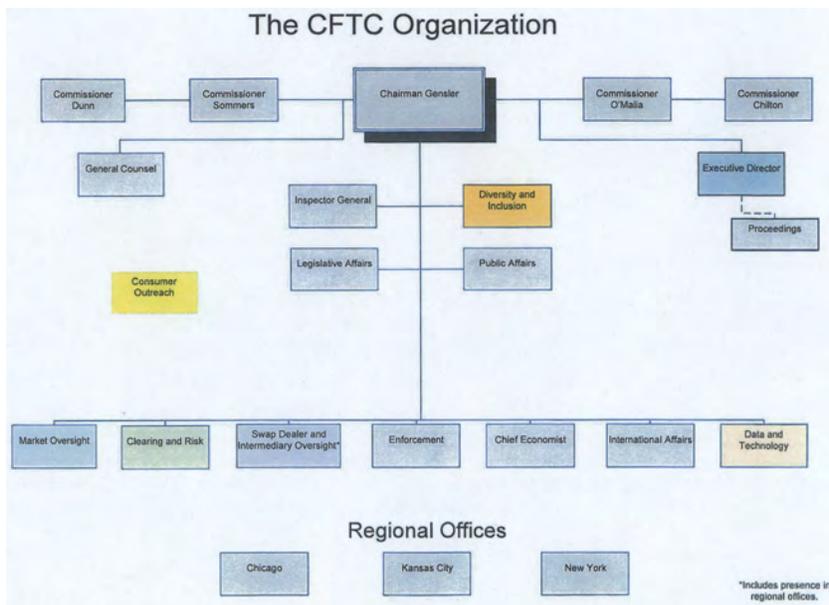
Ensuring that the agency has the capacity and capability to effectively manage an expanded mission requires the establishment of one new functional program and the consolidation of a number of functions. These changes will reduce the number of Executive Director direct reports from eight to five. The direct reports will now consist of Business Management and Planning; Financial Management; Human Resources; Records Management; and Diversity and Inclusion.

Office of Diversity and Inclusion

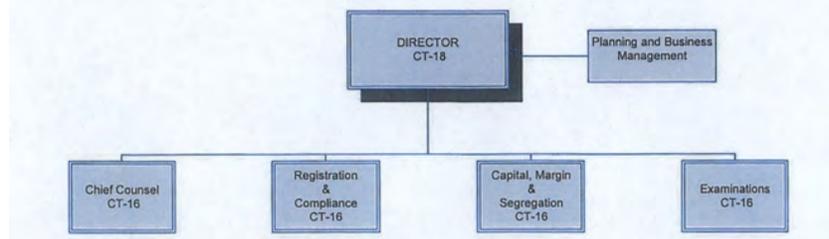
The Office of Equal Employment Opportunity will be renamed the Office of Diversity and Inclusion to accurately reflect the programmatic responsibilities of the Office. In addition to handling complaints filed pursuant to 29 CFR 1614, the current EEO Office ensures that the CFTC has a positive and progressive affirmative employment program that will assist the agency in attracting a diverse workforce. The Office will continue to assess and evaluate the CFTC environment and identify any potential barriers to inclusion, including reviewing practices and policies. The proposed name change is consistent with the names of other Federal agencies (e.g., Federal Reserve Board, Department of Treasury and Office of Personnel Management).

Consumer Outreach Program

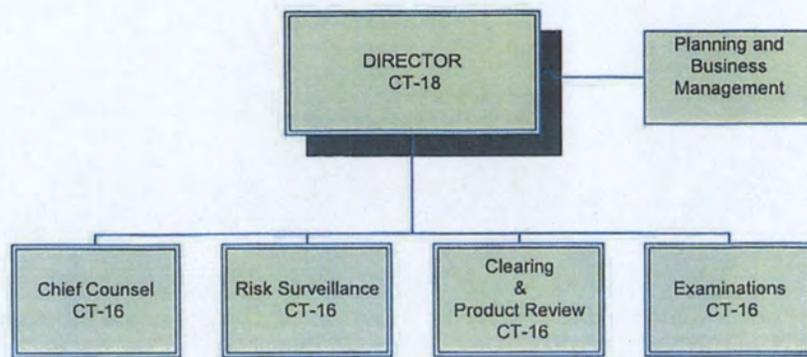
The Dodd-Frank Act establishes the CFTC Customer Protection Fund (Fund). The Fund is to be available for payments to whistleblowers who provide information in connection with violations of the Commodity Exchange Act (the Act) and to finance education initiatives designed to help customers protect themselves against fraud and other violations of the Act. A Consumer Outreach Program Working Group of Commission staff will make recommendations by May 31, 2011, for the appropriate organizational structure of the outreach effort.



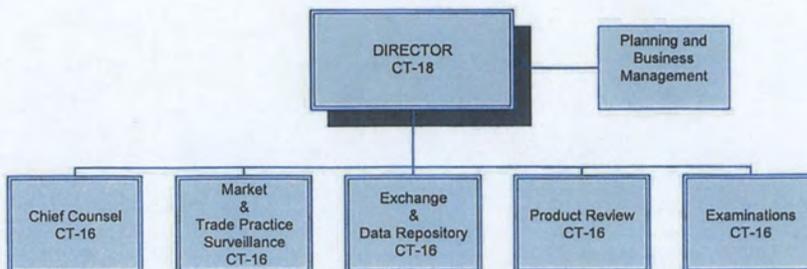
Division of Swap Dealer and Intermediary Oversight



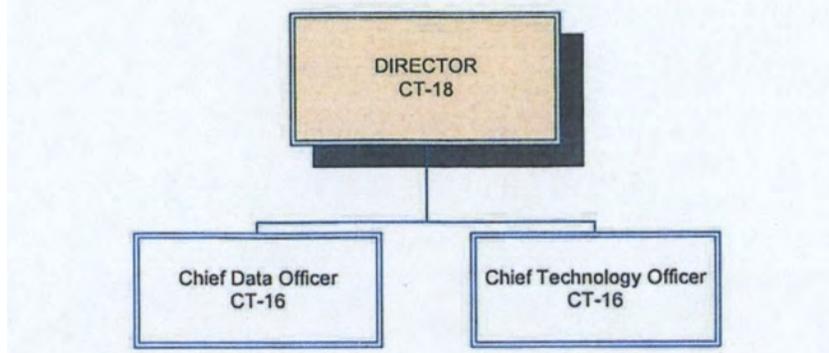
Division of Clearing and Risk



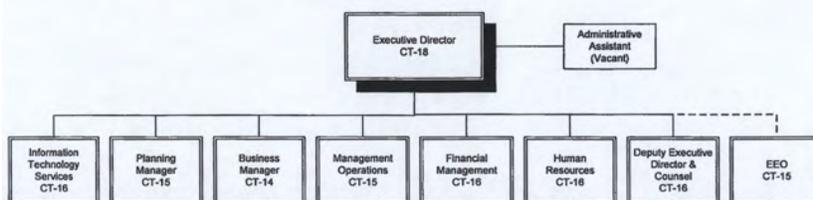
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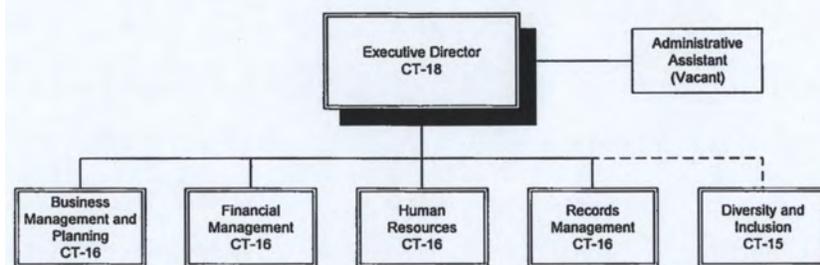
Office of Data and Technology



Office of the Executive Director (Current State)



Office of the Executive Director (Future State)



Question. What resources will this require?

Answer. The President's budget proposes \$308 million for the CFTC for fiscal year 2012 to remain available until expended through fiscal year 2013. This funding level would enable the Commission to perform its responsibilities both in the oversight of commodity futures markets and in beginning to oversee the swaps markets.

The fiscal year 2012 budget request would provide funding for 983 employees. Though increased funding will support approximately 37 percent more staff, it is in light of a congressional mandate that expands the CFTC's scope by more than seven

times. The request also includes \$66 million for technology, of which \$41 million would be used to fulfill pre-Dodd-Frank Act information technology requirements. This increase would allow the CFTC to invest in technology in an effort to keep pace with the futures marketplace that is increasingly populated by algorithmic and high-frequency traders.

Question. Chairman Gensler, in your prepared remarks, you mentioned the proposal for setting up a new group for the collection, management, and analysis of data for improved oversight and enforcement in the derivatives markets and as the primary interface for market participants in adapting to the new data standards and reporting requirements for market data required under the Dodd-Frank Act.

When do you anticipate this being launched?

Answer. It is anticipated that the Office of Data and Technology and its Data Management Branch will be launched as part of the staff reorganization discussed above on October 9, 2011.

TECHNOLOGY MODERNIZATION INVESTMENTS

Question. As emphasized in the CFTC's 2011–2015 strategic plan, “effective oversight can only be accomplished if the regulator has access to all relevant activity in the markets.”

The volume of information and data is vast. Promptly collecting, synthesizing, managing, and analyzing all of it is paramount in your surveillance work and real-time public reporting. Without question, enhanced cutting-edge technology is essential to the CFTC's capacity to leverage financial and human resources to execute not only your core mission, but for fulfilling the expanded responsibilities under Dodd-Frank reforms.

During the period of successive short-term continuing resolutions (October 1–April 15), the budget for the Office of Information Technology Services was reduced 36 percent in order to preserve existing CFTC staffing levels.

What is your vision for the critical role of technology and automation in policing the futures and swaps marketplaces?

Answer. The CFTC's fiscal year 2012 budget request includes \$66 million for technology. This will allow us to pursue automated surveillance to oversee the markets and to make our oversight more efficient.

Despite rapid advances in technology and the increased size of regulated derivatives markets, funding for the CFTC has lagged behind the growth of the markets. While market participants have the technology to automate their trading, we do not yet have the resources to employ modern technology to automate our surveillance.

In fiscal year 2010, we used about 18 percent of our budget—\$31 million—on technology initiatives. The continuing resolution requires that we allocate \$37.2 million toward technology in fiscal year 2011. The CFTC needs to make further investment in technology to efficiently oversee both the futures and swaps markets. Only through investment in the CFTC will we be able to adequately oversee the commodity futures and swaps markets and protect the American public. The President's fiscal year 2012 budget provides for \$66 million to be used on technology, which would increase the proportion of our budget used on technology to more than 21 percent.

Question. How would you characterize the CFTC's current state as compared to the industry you regulate?

Answer. The CFTC's fiscal year 2010 year-end staff of 682 compares to approximately 800,000 people employed by U.S. brokerage firms, according to the Department of Labor's Bureau of Labor Statistics. That is out of a financial industry that employs 5.6 million people. Furthermore, the CFTC's funding request of \$308 million compares to approximately \$814 million in annual revenues of the top 25 bank holding companies according to industry filings with the Federal Reserve. The CFTC's technology budget of approximately \$31 million during fiscal year 2010 compares to about \$20–25 billion spent by U.S. broker/dealers on technology initiatives per year, according to a presentation recently given to the CFTC's Technology Advisory Committee by the TABB Group.

Question. What new investments are called for?

Answer. Technology will play a critical role in leveraging financial and human resources as the CFTC executes its expanded oversight and surveillance responsibilities pursuant to the Dodd-Frank Act. Accordingly, the CFTC will establish a new group for the collection, management, and analysis of data. This group will facilitate improved oversight and enforcement in the derivatives markets through the use of technology and data. It also will serve as the primary interface for market participants in adapting to the new data standards and reporting requirements for market data required under the Dodd-Frank Act.

The CFTC's fiscal year 2010 budget request includes \$25 million for technology needed to implement the Dodd-Frank Act. The resources requested are necessary for the CFTC to invest in direct data links to swap data repositories that are being established in the United States and internationally. The CFTC also must have the technology to aggregate and summarize the data for purposes of oversight and surveillance.

Question. What is your timetable for enhancing the CFTC's automated capabilities?

Answer. The President's budget request for fiscal year 2012 would support \$66 million in information technology spending for the CFTC. Of that amount \$25 million will be required to begin the implementation of Dodd-Frank Act rules. The CFTC will begin developing a number of technology solutions in fiscal year 2011 and 2012. This includes: automated surveillance of commodity futures, options and swap markets; ensuring that the CFTC data is compatible with industry data; identifying fields that describe transactions and transacting entities; associating swaps market data with futures market data; and implementing a number of other technology priorities. The technology implementation timetable will be driven by the sequence and phasing of the effective dates of final rulemakings. In fiscal year 2011 and 2012, the focus will be support for registration and compliance filings, providing connectivity for direct access to SDRs, addressing margin requirements and assimilating data needed for determining and enforcing position limits. The CFTC plans to update automated surveillance systems and integrate swaps and futures data and systems.

Question. What can reasonably be accomplished this year?

Answer. The fiscal year 2011 information technology (IT) program budget is \$37.2 million. The largest percentage of the CFTC IT budget supports the ongoing operations of mission-essential systems and infrastructure for all divisions. With this funding, the CFTC can meet emerging business requirements, determine business requirements for new technology solutions, implement new technology solutions, and provide operations support.

Question. When you testified before the subcommittee a year ago, you stressed that "timely reporting of quality and meaningful market information is not possible with current legacy systems (one with position data and one with trade data)". Has anything changed on that front?

Answer. The CFTC has continued to improve the quality of the trade data that it receives by migrating additional exchanges to a standards-based data feed. We expect to complete the migration for exchanges with relatively low volume by the end of fiscal year 2011. Overall, the quality of futures trade and position data is improved. Challenges remain regarding a consistent ability to correlate trade and position data, but we have begun work on the high-level design of the IT architecture needed to solve them.

Question. What impediments does the CFTC currently face in becoming—and remaining—as sophisticated and savvy as possible when it comes to technological support for your work?

Answer. The swaps marketplace is seven times the size of the futures marketplace, and technology is necessary to manage our regulatory responsibilities. The CFTC will require significantly more resources to undertake regulation of the swaps market, to assimilate and analyze data from SDRs and to respond in a timely fashion to inquiries from market participants.

RULEMAKING

Question. Before the ink was dry on the Dodd-Frank Act last July, the CFTC hit the ground running to comport with explicit statutory timetables for issuance of proposed rules and studies for the governance of the swaps marketplace and other components of the comprehensive reform.

Under your leadership, Chairman Gensler, the CFTC established 31 discrete staff teams concentrated on specific aspects of the array of rules. As of today, the CFTC has issued more than 40 proposed rules for public comment and has demonstrated laudable transparency in making available on its Web site the public comments it has received as well as information about meetings held with external stakeholders and interested persons.

The staff of the CFTC has assumed an unprecedented workload and uninterrupted schedule to develop the rule proposals.

What are the lessons learned since July as you have pursued the rulemaking challenge?

Answer. Since July, the CFTC has issued more than 50 notices of proposed rulemaking to implement the Dodd-Frank Act. During that time, Commissioners and

CFTC staff have held hundreds of meetings with the public and market participants and have received more than 20,000 comments. From these meetings and comments, the CFTC has learned a great deal about existing market structures, including how swaps are transacted and how market participants structure their clearing and credit arrangements. This information has been extremely valuable in crafting proposed rules and will be important in finalizing those rules.

Question. What benefits do you expect to derive from extending and reopening the comment period on the proposed rules?

Answer. In late April, the CFTC voted to reopen the comment period on most of the Dodd-Frank proposed rules for an additional 30 days to give market participants another opportunity to comment on the entire mosaic of the rulemakings. The additional comment period allowed the CFTC to gain further insights from market participants and the public regarding proposed rules and their interaction.

Question. What guidance has emerged from the 2-day session the CFTC and the Securities and Exchange Commission (SEC) jointly held this week for how the final rules will be phased-in?

Answer. On May 2 and 3, the CFTC and SEC jointly held a staff roundtable to obtain the views of the public and market participants concerning the implementation of title VII of the Dodd-Frank Act. During those sessions, participants described what steps they would need to take to implement proposed Dodd-Frank rules. Participants also provided information about the interdependencies of various parts of title VII, including clearing, trading and reporting, and advised the CFTC about how implementation might be logically phased.

Question. What's next on your agenda?

Answer. The CFTC will consider final rules through the summer and fall months. To that end, the CFTC has scheduled five Commission meetings thus far: two in July, one in August and two in September.

Question. When do you project that the full mosaic of rules will be finalized?

Answer. The CFTC is beginning to take up final rules this summer and expects to continue finalizing rules through the fall.

Question. Is there a nexus between your timetable for finalizing the rules and having the trained staff on board and supportive technology in place to ensure that transactions are monitored and rules enforced?

Answer. We anticipate issuing final rules to implement the Dodd-Frank Act through the summer and fall and bringing on necessary staff and technology improvements throughout fiscal year 2012 and fiscal year 2013. We have begun the process to fill many important positions.

POSITION LIMIT REQUIREMENTS AND OIL SPECULATION TASK FORCE

Question. In 2008, as energy and grain prices set new records, speculators in derivatives were blamed by some for price volatility and for price levels that many observers believed were not justified simply by the underlying economic fundamentals of supply and demand. The CFTC maintained that markets were functioning normally and that the price discovery process was not being distorted.

The enactment of Dodd-Frank included several provisions designed to insulate commodity prices from the impact of excessive speculation and manipulation. For example, under section 737, the CFTC is directed to establish position limits—a cap on the size of the bets—for both swaps and futures.

January 22, 2011, was the statutory deadline for the new position limit rules. It is my understanding that the CFTC has delayed the rules issuance in order to collect more data.

With oil and gas prices soaring daily, there's mounting concern about the role of speculators in driving the price surge, and questions being raised about what needs to be done to curb it.

A few weeks ago, President Obama announced the formation of a new inter-agency working group led by Attorney General Holder to examine the gas price situation. Representatives of both the CFTC and SEC are among the membership of this task force. Among the topics to be explored are fraud in the oil markets, developments in the commodity markets, investor practices, supply and demand factors, and the role of speculators and index traders in the futures markets.

A similar interagency task force was formed back in 2008. The CFTC also conducted its own study of swap dealers and index traders to determine if their activity was affecting prices in crude oil and agricultural markets. In neither of these studies was a connection made between speculative trading and rising prices.

If speculation is not illegal and serves as a necessary ingredient that adds liquidity to the markets, are there not other mechanisms, such as position limits, margin

requirements, and other expectations that could—or should—be invoked to address this situation?

Answer. The CFTC fulfills its mission to oversee the futures markets through market surveillance, industry oversight, and enforcement. The CFTC pursues fraud and market manipulation and oversees futures exchanges and clearinghouses. The CFTC is a cop on the beat that protects markets in commodity derivatives from fraud, manipulation, and other abuses.

A critical reform of the Dodd-Frank Act relates to position limits. Position limits have served since the Commodity Exchange Act (CEA) passed in 1936 as a tool to curb or prevent excessive speculation that may burden interstate commerce.

Importantly, the Dodd-Frank Act directs the CFTC to establish position limits for both futures and swaps in a very specific manner. First, the act directs the CFTC to establish position limits, as appropriate, for futures contracts for agricultural commodities and exempt commodities (including crude oil, gasoline, and other energy commodities). Second, the act directs that the CFTC concurrently establish position limits on swaps that are economically equivalent to those futures contracts. Third, the act requires the CFTC to establish aggregate limits across the futures and swaps markets. On January 26, the CFTC published a proposed rule to implement these statutory directives. The comment period closed on March 28. The CFTC will evaluate the comments received before proceeding to a final rulemaking. It is essential to complete the task of implementing the aggregate position limits regime, congressionally mandated to guard against the burdens of excessive speculation.

Question. Chairman Gensler, when do you expect the CFTC to act on the requirement for strict position limits on the amount of oil speculators could trade in the energy futures?

Answer. On January 26, the CFTC published a proposed rule to set position limits for crude oil contracts and other physical commodities. The comment period closed on March 28, and the CFTC received more than 12,000 comments. The CFTC will thoroughly review these comments and proceed to developing a final rule.

ENFORCEMENT: PRESERVING MARKET INTEGRITY AND PROTECTING MARKET USERS

Question. Detecting and deterring against illegitimate market forces requires CFTC's steady vigilance and swift response. In fiscal year 2010, the CFTC filed 57 enforcement actions – 14 percent more than in fiscal year 2009 and 43 percent more than in fiscal year 2008. The enforcement filings involve allegations of manipulation, fraud, abuse, and other violations of the CEA.

Furthermore, the CFTC opened 419 investigations of potential violations of the CEA and CFTC regulations. That's an all-time high, far exceeded the target, and is a 66 percent increase more than the 251 investigations opened in fiscal year 2009. In addition, in fiscal year 2010, The CFTC obtained \$200 million in restitution, disgorgement, and civil monetary penalties in previously filed or existing cases.

Let me preface my questions by saying that these statistics are impressive. You and your staff are to be commended. However, does this mean there is more illicit activity going on or that the CFTC is becoming more adept at rooting it out?

Answer. A combination of factors contributed to increased enforcement activity by the CFTC. For example, during the past 2 fiscal years the Division of Enforcement hired additional staff attorneys and investigators to keep up with the demands of the docket; the Division has received a larger number of referrals over the past 2 fiscal years from a variety of lead sources (ranging from customer complaints to referrals from other financial regulators), which increased the number of investigations opened; and the CFTC has been granted new oversight authority (for example, the CFTC filed 13 cases in January 2011 based upon new FOREX registration obligations imposed earlier this fiscal year).

Question. What's projected for fiscal year 2011? Are you on track to build on last year's successes?

Answer. Yes. With less than two-thirds of fiscal year 2011 complete, the CFTC has filed 70 enforcement actions—already more than the number of cases for fiscal year 2010. Approximately 300 new investigations have been opened during this fiscal year.

Question. How well is the CFTC able to measure the deterrent effect of these enforcement actions? Is there a message to fraudsters?

Answer. In response to violations of the CEA and CFTC regulations, the Commission has the authority to seek restitution, disgorgement, imposition of civil monetary penalties, trading restrictions, and registration bans. These remedies are designed to ensure that wrongdoers are punished, and they also serve a deterrent effect. In appropriate cases, the CFTC refers matters to the Department of Justice (DOJ) for criminal prosecution. The CFTC publicly discloses all enforcement actions by posting

each case filing on the Commission's Web site and issuing press releases in connection with every action filed and judgment obtained. The message to wrongdoers is clear: actions that harm customers or markets will be prosecuted.

Question. How rapidly are you able to collect restitution, disgorgement of ill-gotten gains, and civil monetary penalties imposed against violations of the Federal commodities laws? What is the recovery rate?

Answer. Since fiscal year 2002 more than \$1.6 billion has been imposed in restitution and disgorgement orders. Judgments entered in CFTC enforcement actions for restitution and disgorgement have been imposed to compensate victims for their losses and direct violators to pay the victims. As a result, restitution and disgorgement are not collected by the Government.

From fiscal year 2002 to March 2011, more than \$1.7 billion in civil monetary penalties (CMP) have been imposed. Of that amount, more than \$500 million has been collected and deposited in the U.S. Treasury. All CMP debts are handled by the Department of the Treasury for collection actions and resolution. If the Department of the Treasury is unsuccessful in expeditiously collecting the CMP debt and there is sufficient reason to conclude that full or partial recovery of the debt can best be achieved through litigation, the CFTC refers the debt to the DOJ for enforced collection and resolution as appropriate.

Question. What has been the impact of more sophisticated information technology to monitor and detect fraud more readily given the complexity of transactions? How well is the eLaw Program working?

Answer. The Divisions of Market Oversight and Enforcement employ a variety of nonpublic investigative methods to monitor and evaluate trading activity. The Division of Enforcement's eLaw Program has proven effective as a comprehensive litigation management program, which is currently being upgraded. The eLaw Program has facilitated information sharing across the Division of Enforcement and increased the efficiency of document and audio search and review, as well as data analysis. eLaw also has increased the efficiency and organization of case development and management, including investigations and litigation, reduced the duplication of research and analysis, enhanced coordination with other agencies and provided the Division with expanded capacity to retain significant historical data.

The eLaw Program's addition of a computer forensics capability has increased the efficiency of electronic evidence preservation, collection and analysis. With the addition of in-house computer forensics, the Enforcement Division no longer has to incur high-vendor costs or delays from outsourcing the work. This includes the addition of a forensics lab that facilitates proper storage and control of electronic evidence for chain of custody purposes. The forensics program has provided a foundational framework for ensuring that electronic evidence to be used in enforcement matters is admissible in court.

The workload for the eLaw Program has grown exponentially since its inception. Additional staffing and resources will facilitate the timely and effective services provided by the systems and personnel upon which the program relies. In addition, as derivatives markets expand and become more sophisticated, and as the CFTC's authority to regulate those markets expands, the updated eLaw Program will ensure that personnel can undertake the sophisticated analyses necessary for efficient enforcement investigations.

Question. Are there any statutory or administrative impediments that prevent the CFTC from doing more to combat fraud? What tools do you lack?

Answer. In the coming months, the CFTC will begin integrating a broad range of enforcement tools, such as increased fraud, manipulation, and disruptive trading practices authority authorized by the Dodd-Frank Act. The CFTC's proposed anti-manipulation rule would set in place a broad new ability to effectively combat fraud and manipulation. The proposed rulemaking promotes fair and efficient markets, for the first time allowing the CFTC to explicitly act against fraud-based manipulation. The Congress also gave the CFTC authority to prohibit trading practices that are disruptive of fair and equitable trading. With adequate resources, these and other authorities will be used by the CFTC to promote and ensure fair and orderly trading, free from fraud, manipulation, and other abuses.

AUDIT FREQUENCY

Question. The CFTC regulates the activities of 64,700 registrants who handle customer funds, solicit or accept orders, or give trained advice. Among these registrants are commodity pool operators, futures commission merchants, floor brokers, floor traders, and associated persons (salespersons). The CFTC delegates oversight authority to the National Futures Association, a self-regulatory organization (SRO).

The CFTC is limited to conducting reviews of Commission registrants, on average, just once every 3 years, thereby diluting the ability to check compliance. The CFTC also would prefer to perform regular and direct reviews of all exchanges and intermediaries and to assess their compliance with the CEA rather than relying on designated SROs for these reviews.

What would be the advantages of performing more frequent reviews, (e.g., annual ones)?

Answer. Direct examination of market intermediaries is a key component of the oversight program for SROs and registrants. Direct examinations are essential to assessing the effectiveness and thoroughness of an SRO's financial surveillance program. They also provide independent verification of audit work completed by SRO's staffs. Direct examinations also allow the CFTC to take immediate action when necessary to assess compliance with the CFTC's financial requirements to protect customers and ensure orderly markets. As registration and other requirements for swap dealers and major swap participants come into effect, these examinations will provide CFTC staff with critical information about the operation of these entities and their compliance with CFTC requirements.

Question. Would more frequent reviews require adding staff with expertise in trading and build CFTC's knowledge base of how exchanges' various electronic trading platforms operate and how violations may occur on and across electronically traded markets?

Answer. More frequent reviews would require adding staff with trading expertise. Having staff with expertise regarding how exchanges' electronic trading platforms operate is key to assessing exchanges' self-regulatory programs and compliance with core principles, as well as understanding how violations can occur across markets. In the past, exchanges typically did not trade the same products. However, in the past few years, exchanges have been listing and trading similar products. For example, some metals trade at both NYSE Liffe and COMEX and ELX trades; Eurodollar futures and Treasury Note futures—products that trade on CME and CBT, respectively. Protecting the public interest requires that the CFTC understand how all of the exchanges' electronic trading platforms work and how a trade on one exchange can be executed to facilitate a trading violation at another exchange.

Question. To what extent do you believe there is a risk that an ineffective self-regulatory program may go undetected or a systemic risk may not be identified if frequency of reviews remains triennial?

Answer. More frequent reviews will allow the CFTC to have current information on the effectiveness of surveillance programs and to identify and address potential issues on a timelier basis. The number of entities that must be assessed is expected to increase considerably as a result of the Dodd-Frank Act. Swap dealers and major swap participants will be required to register and to comply with applicable requirements regarding business conduct, reporting and record-keeping, capital, and margin. These entities will be subject to review by the CFTC or an SRO with respect to their compliance with the applicable requirements. Resources will be necessary to establish and implement programs for direct review by CFTC staff of these new registrants and for oversight of SROs that may have primary responsibility for review of these entities.

COST-BENEFIT ANALYSIS ISSUE

Question. In the CFTC's draft 2011–2015 Strategic Plan, the agency declares that the Commission will adopt as policy President Obama's Executive order signed January 18, 2011, entitled "Improving Regulation and Regulatory Review" and apply that standard to all future and ending rulemakings under Dodd-Frank and seek to streamline existing rules and regulations as well.

There's been criticism of late that suggests that the CFTC is not adhering to this Executive order. I suspect some of that hype may be a stalling tactic to put the brakes on Dodd-Frank reforms.

I think CFTC has made it abundantly clear that as an independent agency, the CFTC is exempted from the Executive order, and that the CFTC follows its statutory mandate that require the consideration of the costs and benefits of the actions before issuing a rulemaking.

Section 15(a) of the CEA enumerates five broad areas of market and public concern that shall be taken into account in evaluating costs and benefits. These are:

- protection of market participants and the public;
- efficiency, competitiveness, and financial integrity of markets;
- price discovery;
- sound risk management practices; and
- other public interest considerations.

The CFTC has discretion to give greater weight to any one of these criteria, and could determine that, notwithstanding the costs, a particular rule is necessary or appropriate to protect the public interest or accomplish any of the purposes of the law.

Can you explain your approach to rulemaking and help dispel the myth that you are deviating from the spirit of the Executive order when it comes to conducting regulatory cost-benefit analysis as you roll-out the implementation of the Dodd-Frank regulations?

Answer. The CFTC's practices are consistent with the Executive order's principles. The CFTC conducts cost-benefit analyses in its rulemakings as prescribed by the Congress in section 15(a) of the CEA. The statute includes particularized factors to inform cost-benefit analyses that are specific to the markets regulated by the CFTC. Thus, we will continue to fulfill the CEA's statutory requirements.

The CFTC has benefited from public comments relating to the costs and benefits of proposed rules. To further facilitate this process, the CFTC approved reopening or extending the comment periods for most of our Dodd-Frank proposed rules for an additional 30 days through June 3, 2011. Commissioners and staff have met extensively with market participants and other interested members of the public about our rulemakings. CFTC staff hosted a number of public roundtables so that rules could be proposed in line with industry practices, minimizing compliance costs while fulfilling the Dodd-Frank Act's statutory requirements. Information about each of these meetings, as well as full transcripts of the roundtables, is available on the CFTC's Web site.

PROMOTING MARKET TRANSPARENCY THOROUGH PUBLICIZED INFORMATION

Question. Each week, the CFTC publishes its "Commitments of Traders" (COT) report. This provides a breakdown of each Tuesday's open interest for markets in which 20 or more traders hold positions equal to or above the reporting levels established by the CFTC. Since September 2009, the reported data has been disaggregated to break out managed money and swap dealer activity in the futures and option markets. The CFTC also produces an index investment data report, which summarizes index investment activity in commodity markets, a bank participation in futures and option markets report, and a Cotton On-Call report.

All of these efforts to make information available to the public are important.

What are your plans to continue similar efforts to promote transparency in the swaps market through the development and publication of reports for that market?

Answer. The CFTC currently publishes COT reports that include aggregate data from futures and options exchanges. Pending the outcome of Dodd-Frank rulemakings and the availability of adequate resources, similar transparency efforts will be undertaken with respect to the swaps market. The CFTC's proposed rule requiring the reporting of positions in certain swaps will provide crucial data that will be incorporated in COT reports.

Question. What other efforts are underway—or planned—at the CFTC to heighten access to information and thus promote more open government?

Answer. The CFTC is committed to promoting transparency of both the markets and the agency. We have posted on our Web site a list of all meetings held with outside organizations related to Dodd-Frank rulemakings. This allows the public to see what information is provided to the agency during the rulemaking process.

Further, we plan to implement new transparency initiatives in the coming weeks. Specifically, we will release data sets that provide information on the daily volume of trading that represents changes in daily net market exposure. The CFTC also seeks to make COT data more user-friendly. At present, users are presented with a fixed list of reports. Proposed changes will present options from which users can choose to generate the reports and formats that come closest to serving their needs.

Question. The amount and detail of trade data collected and analyzed at the CFTC is unprecedented among regulatory financial agencies. The backbone of the CFTC's market surveillance program is the large trader reporting system. I understand that the SEC is exploring a similar system. Based on your experience at the CFTC, what best practices or lessons learned might benefit what Chairman Schapiro is contemplating?

Answer. Trader identification that permits aggregation according to common ownership and control, and that allows for meaningful classification of traders would ease analysis and formatting of published reports. We are working closely with the SEC to share our experience with large trader reporting.

WORKING WITH SWAP EXECUTION FACILITIES (SEF)

Question. Currently the CFTC oversees 17 Designated Contract Markets (DCMs) for trading in futures. It is my understanding that the CFTC anticipates that some 30–40 entities will apply to become SEF, potentially tripling the CFTC’s oversight requirements. New responsibilities include routine monitoring and surveillance to screen for potential market manipulation, disruptive trading practices, and violations, as well as changing market conditions and developments.

Is the range of 30–40 still your projected estimate on the growing universe over which the CFTC will need to exercise vigilance?

Answer. The range of 30–40 possible SEFs was an estimate based on the number of entities that expressed interest in establishing SEFs. The CFTC staff continue to receive inquiries from entities that may register as SEFs. The actual number of entities that ultimately will file applications is uncertain.

Question. What additional resources will be required for CFTC to even minimally satisfy its new oversight in the swaps arena?

Answer. The CFTC will need additional staff to implement many new provisions related to the oversight of swaps trading activity. These include procedures for the review and oversight of an entirely new regulated market category: SEFs. Staff in the Market and Product Review and Market Compliance units must establish and implement procedures for the review of new SEF applications and for the annual examination of the operations of SEFs. The CFTC has requested a total of 62 FTE to fulfill its pre-Dodd-Frank responsibilities. A total of 56 FTE are requested to implement new Dodd-Frank Authorities. This includes an additional 38 FTE for fiscal year 2012 and an additional 18 FTE for fiscal year 2013.

Question. What does the CFTC consider to be the optimum frequency for conducting “rule enforcement reviews” (RERs) of DCMs and eventually SEFs as well?

Answer. Annually.

Question. What resource needs does that necessitate?

Answer. The President’s budget request for fiscal year 2012 would support the expenditure of \$16.6 million for market oversight. This would provide the resources necessary to increase the frequency of reviews.

 QUESTIONS SUBMITTED BY SENATOR BEN NELSON

Question. With the ongoing volatility in the marketplace, I think we can all agree on the necessity of implementing the Dodd-Frank Act in a sound and reasonable timeframe to avoiding reckless speculation.

However, I also want us to be mindful that we achieve regulation without strangulation.

Dodd-Frank contained critical protections to ensure that nonfinancial end-users who use future contracts in a legitimate matter to hedge against higher prices are not hampered by unnecessary regulations.

Specifically when it comes to the Commodity Futures Trade Commission’s (CFTC) implementation of rules relating to the definition of a swap dealer, the end user exception, and position limits.

Chairman Dodd and Chairwoman Lincoln drafted a letter to the CFTC urging the Commission to be mindful of these specific protections in its implementation of the law, which I would like to introduce for the record.

Is the CFTC following congressional intent when it comes to protecting commercial end users so they are not adversely impacted by the Dodd-Frank’s regulatory framework?

Answer. To ensure the financial integrity of swap dealers and security-based swap dealers, the Congress directed that prudential regulators, the Security and Exchange Commission (SEC) and the CFTC establish capital and margin requirements. The Dodd-Frank Act also requires that standardized swaps be cleared by central counterparties to lower risk. The CFTC’s proposed rules would not require clearing or margin for uncleared swaps to be paid or collected on transactions involving nonfinancial end-users hedging or mitigating commercial risk.

Question. As I mentioned in my opening statement, the run up in commodity prices, in particular oil and gas prices are having a major impact on Nebraska families, farmers, and businesses that rely on affordable fuel for personal commuting, farming, and conducting day-to-day commerce.

In 2008, the CFTC found that the oil record was partly driven by speculators driving up prices. Does the CFTC believe this to be the case again with the run up in commodity prices? How much has this speculation inflated oil and gas prices?

What steps is the CFTC taking to address this?

Answer. The CFTC fulfills its mission to oversee the futures markets through market surveillance, industry oversight, and enforcement. The CFTC pursues fraud and market manipulation and oversees futures exchanges and clearinghouses. The CFTC is a cop on the beat that protects markets in commodity derivatives from fraud, manipulation and other abuses.

A critical reform of the Dodd-Frank Act relates to position limits. Position limits have served since the Commodity Exchange Act passed in 1936 as a tool to curb or prevent excessive speculation that may burden interstate commerce.

Importantly, the Dodd-Frank Act directs the CFTC to establish position limits for both futures and swaps in a very specific manner. First, the act directs the CFTC to establish position limits, as appropriate, for futures contracts for agricultural commodities and exempt commodities (including crude oil, gasoline, and other energy commodities). Second, the act directs that the CFTC concurrently establish position limits on swaps that are economically equivalent to those futures contracts. Third, the act requires the CFTC to establish aggregate limits across the futures and swaps markets. On January 26, the CFTC published a proposed rule to implement these statutory directives. The comment period closed on March 28. The CFTC will evaluate the comments received before proceeding to a final rulemaking. It is essential to complete the task of implementing the aggregate position limits regime, congressionally mandated to guard against the burdens of excessive speculation.

Question. In the current fiscal climate we are faced with many difficult questions when it comes to funding.

While we were able to boost the CFTC budget by \$34 million more than fiscal year 2010 levels for the remainder of fiscal year 2011, it appears we face an even more difficult situation for funding fiscal year 2012.

Can you speak to the limitations the CFTC would have in regulating contracts and providing oversight and transparency to the over-the-counter derivatives swaps trading market if we are merely able to maintain fiscal year 2011 levels in fiscal year 2012?

What would the impact be if we were faced with the prospect of being able to only provide fiscal year 2008 levels or the level the House recently passed in their fiscal year 2012 budget proposal?

Answer. A return to the CFTC's fiscal year 2008 funding level would represent a 45 percent reduction from current levels. Had such a level been enacted for the CFTC mid-way through fiscal year 2011, CFTC staffing would have had to be reduced by 442 FTE—a 65 percent reduction.

If the CFTC's funding returned to the fiscal year 2008 level, the Commission would be unable to fulfill its statutory mission. Every program would be affected, including market surveillance, industry oversight and enforcement. We would be unable to pursue fraud, such as Ponzi schemes, and market manipulation. We would inevitably develop a backlog of registration applications, rule reviews and appellate filings. This would leave significant uncertainty in the marketplace.

Question. Over the Easter recess, President Obama directed Attorney General Eric Holder to create an Oil and Gas Price Fraud Working Group to "monitor oil and gas markets for potential violations of criminal or civil laws to safeguard against unlawful consumer harm."

It is my understanding that in addition to the Department of Justice the group is composed of representatives from the Federal Trade Commission (FTC), the Department of the Treasury, and the CFTC.

I was hoping you could speak to the role CFTC is play in this working group and what we hope to accomplish with this new working group.

Answer. The CFTC serves as a co-chair of the Oil and Gas Fraud Working Group, whose membership also includes State Attorneys General, the FTC, the Departments of Energy, Agriculture and the Treasury, the SEC, the Board of Governors of the Federal Reserve System and the Federal Bureau of Investigations. On May 6, 2011 Attorney General Holder, as chairman of the group, informed the members that the "[w]orking Group will enable us to formalize our collaborative effort, share current oversight activities, avoid duplication, and combine our resources and expertise." Members are actively working toward these goals, covering topics such as confidential information sharing between agencies, evaluating lessons learned from prior fraud enforcement involving multiple regulator collaboration and coordination, and continued discussions regarding market fundamentals, trends and oversight.

QUESTIONS SUBMITTED BY SENATOR JERRY MORAN

Question. The recently enacted continuing resolution states that of the funding provided, "not less than \$37.2 million shall be for the highest-priority information

technology (IT) activities in the Commission” to address important IT needs such as automated surveillance, collecting order and trade data, integrating technology across swaps and futures markets, improving data transparency and linking the Commodities Futures Trading Commission (CFTC) with Swap Data Repositories (SDR). Please identify the highest-priority IT activities that will be funded from within this amount.

The highest priority of the CFTC IT budget is to support the ongoing operations of mission-essential systems and infrastructure for all divisions. With this funding, the CFTC can meet existing business requirements, provide operations support, collect business requirements for new technology solutions and implement new technology solutions. The major services provided in this area include:

- Establishment of a technology roadmap with the capability and capacity to integrate futures and swaps data and market oversight;
- Market and financial surveillance;
- Enforcement litigation support, data discovery and forensics;
- Automated surveillance modeling; and
- Large trader data, financial data and trade data receipt, loading and mining.

Question. As the full-year continuing resolution has been enacted, please provide details to the subcommittee as to how the CFTC plans to spend remaining fiscal year 2011 funding. According to the Chairman’s prepared testimony, the CFTC is prepared to hire approximately 40 additional staff in fiscal year 2011. Please provide the subcommittee with specific information on the basis of the Chairman’s hiring figure and the CFTC’s intended deployment of the additional personnel. In addition to information about hiring plans, please also provide specific information as to the impact those hiring decisions will have on the staffing increases requested by the CFTC for fiscal year 2012.

Answer. The fiscal year 2011 spending plan allocates \$202,269,650 across 2 fiscal years, the majority of which will be obligated before September 30, 2011.

The CFTC expects to have about 720 staff on-board by September 30 and to utilize 667 full-time equivalent staff-years. Twelve of the new positions will implement the CFTC’s reorganization. The remaining hires will be used to fill critical staffing needs across the CFTC. The display below identifies the expected distribution of CFTC staff at the end of fiscal year 2011.

DISTRIBUTION OF CFTC STAFF

Division/office	2011 distribution by division at 720 FTE level	Percentage of staff
Division of Enforcement	172	23.9
Division of Market Oversight	126	17.5
Division of Clearing and Risk	59	8.2
Division of Swaps Oversight	79	11.0
Office of Data and Technology	88	12.2
Office of the Executive Director Office of General Counsel	69	9.6
Office of Chairman and Commissioners	50	6.9
Office of the Chief Economist Office of Proceedings	42	5.8
Office of International Affairs Office of Consumer Outreach	15	2.1
Total	720	100.0

Question. Please provide more details regarding the CFTC’s fiscal year 2012 request for its technology budget, including specific information as to breakdown of the budget request for the newly proposed Office of Technology.

Answer. The following table breaks down the request.

[In millions of dollars]

Description	Amount
Investments in CFTC SDR data aggregation, order Data Collection and Standardization, Implement Advanced Computing Platforms for High-Frequency, Algorithmic Trading Surveillance, and Enforcement	10
Systems integration of existing large trader and trade systems with swaps data, for systems enhancement such as aggregated position limit surveillance, and significant upgrades to the FILAC systems for SEFs and SDRs	9
Capital equipment and software purchases	14
Telecommunication services	5

[In millions of dollars]

Description	Amount
Support services such as financial and legal information services, operations and maintenance, systems analysis for ISS, TSS, eLaw, as well as other smaller mission-supporting systems and general operational support	24
IT supplies, operations, and maintenance including intra-governmental payments or cross-services agreements with other government agencies for Internet access and Web site maintenance, personnel payroll system, GSA telephone services and COOP facilities	4

Answer. The CFTC's fiscal year 2012 budget request includes \$66 million for technology. Of that amount \$25 million will be required to begin the implementation of Dodd-Frank Act rules. The CFTC will begin developing a number of technology solutions in fiscal year 2011 and 2012. This includes: automated surveillance of commodity futures, options and swap markets; ensuring that CFTC data is compatible with industry data; identifying fields that describe transactions and transacting entities; associating swaps market data with futures market data; and implementing a number of other technology priorities. The technology implementation timetable will be driven by the sequence and phasing of the effective dates of final rulemakings. In fiscal year 2011 and 2012, the focus will be support for registration and compliance filings, providing connectivity for direct access to SDRs, addressing margin requirements and assimilating data needed for determining and enforcing position limits. The CFTC plans to update automated surveillance systems and integrate swaps and futures data and systems.

Despite rapid advances in technology and the increased size of regulated derivatives markets, funding for the CFTC has lagged behind the growth of the markets. While market participants have the technology to automate their trading, we do not yet have the resources to employ modern technology to automate our surveillance.

In fiscal year 2010, we used about 18 percent of our budget—\$31 million—on technology initiatives. The continuing resolution requires that we allocate \$37.2 million toward technology in fiscal year 2011. The CFTC needs to make further investment in technology to efficiently oversee both the futures and swaps markets. Only through investment in the CFTC will we be able to adequately oversee the commodity futures and swaps markets and protect the American public. With an appropriation to support \$66 million to be used on technology, the CFTC would increase the proportion of its budget used on technology to more than 21 percent.

Question. The CFTC has recently notified the subcommittee of its intent to undertake a reorganization, effective October 9, 2011, to restructure its staff, creating a new Division of Swap Dealer and Intermediary Oversight, a new Office of Data and Technology, and realigning other divisions and offices including the Division of Market Oversight, the Division of Clearing and Intermediary Oversight and the Office of the Executive Director. The CFTC's fiscal year 2012 budget request did not reflect this reorganization. Please provide the subcommittee with details on the new spending plan the CFTC is proposing for fiscal year 2012, including the impact of the reorganization on staffing.

Answer. The reorganization will require the same FTE level as previously requested. The attached document details the breakdown of FTE utilization under both the fiscal year 2012 budget request and under the planned reorganization.

Department	Employees
Fiscal year 2010 budget current organizational structure:	
DOE	235
DMO	250
DCIO	182
OITS	92
OED	73
OGC	70
CH/COMM	38
OCE	20
PRO	10
OIA	13
CP/WB	
Total	983

Department	Employees
Fiscal year 2012 budget proposed (February) organizational structure:	
DOE	235
OSEF&STDCM ¹	100
MTPS&DMA ²	147
FBOT ³	3
Subtotal	250
SDIO ⁴	112
CORS ⁵	⁵ 70
Subtotal	182
OITS	92
OED	73
OGC	70
CH/COMM	38
OCE	20
PRO	10
OIA	13
CP/WB	
Total	983
fiscal year 2012 budget proposed (May) organizational structure (effective October 2011):	
DOE	235
DMO	¹ 229
DCR	74
DSIO	108
ODT	¹ 113
OED	73
OGC	70
CH/COMM	38
OCE	20
PRO	10
OIA	13
CP/WB	(²)
Total	983

¹ Oversight of Swap Execution Facilities and Swaps Trading on DCMS located on page 8 of the electronic version of the CFTC fiscal year 2012 President's budget.

² Market and Trade Practice Surveillance; Data Management and Analysis located on page 8 of the electronic version of the CFTC fiscal year 2012 President's budget.

³ Foreign Boards of Trade located on page 9 of the electronic version of the CFTC fiscal year 2012 President's budget.

⁴ Swap Dealer and Intermediary Oversight located on page 7 of the electronic version of the CFTC fiscal year 2012 President's budget.

⁵ Clearing Oversight and Risk Surveillance located on page 7 of the electronic version of the CFTC fiscal year 2012 President's budget.

⁶ ODT Total FTE is comprised of 92 OITS FTE and 21 FTE transferred from DMO's Information Group.

⁷ Appropriate organization structure to be determined.

Question. During the question and answer portion of our hearing, you referenced that you have economists working on each of the rule-writing teams. Specifically, you said: "We do have a very fine staff of economists. It's about 14. We are wishing in this budget request to grow to 20, but there are also a lot of economists in the rule writing teams that aren't in the Office of Chief Economist." Beyond the 14 economists working in the Office of Chief Economist, could you please list the names of each of the economists dedicated to the rule-writing teams and list the rules they have worked on?

Answer. When the Dodd-Frank Act was enacted, we established 30 rulemaking teams made up of staff from across divisions. An additional team was added to deal with necessary conforming changes to existing CFTC regulations. Below is a list of these teams and lead divisions with the subject of their rule writing responsibility. For each team the names of economists who are not part of the Office of Chief Economist are listed, along with their job titles and divisions.

RULEMAKING TEAMS

Team	Title
Team 1—Registration (SD and MSPs)	(¹)
Team 2—Entity definitions:	
Kuserk, Gregg	Senior Economist
Seong, Somi	Economist
Troia, Rosario	Financial Economist
Team 3—Business Conduct Standards—Counterparties	(¹)
Team 4—Business Conduct Standards—Internal:	
Rothenberg, John Paul	Economist
Team 5—Capital and margin for non-banks:	
Rothenberg, John Paul	Economist
Team 6—Segregation and bankruptcy cleared—DCIO	(¹)
Team 7—DCO Core Principles—DCIO	(¹)
Team 8—Process of Review, Mandatory Clearing—DCIO	(¹)
Team 9—Governance—DCIO	(¹)
Team 10—System Important DCO Rules, Title VIII—DCIO	(¹)
Team 11—End-User Exemptions—OGC:	
Horn, Marshall	Director, Market Surveillance Branch
Team 12—DCM Core Principles—DMO:	
Forkkio, John	Supervisory Industry Economist
Kass, David	Industry Economist
Leonova, Irina	Financial Economist
Price, Gregory	Industry Economist
Benton, Steven	Industry Economist
Murray, Martin	Supervisory Economist
Team 13—SEF Registration Requirements—DMO:	
Benton, Steven	Industry Economist
Kass, David	Industry Economist
Leonova, Irina	Financial Economist
Price, Gregory	Industry Economist
Team 14—FBOT Registration Requirements—DMO:	
Colling, Phillip	Industry Economist
Team 15—Rule Certification and Approval—DMO:	
Babula, Ronald	Economist
Murray, Martin	Supervisory Economist
Team 16—SDR Registration Standards—OGC:	
Schubert, Anne	Economist
Team 17—Swap Data Recordkeeping and Reporting—DMO:	
Irina Leonova	Economist
Kuserk, Gregory	Senior Economist
Pullen, George	Economist
Rothenberg, John Paul	Economist
Schubert, Anne	Economist
Larry Grannan	Economist
Team 18—Real Time Reporting—DMO:	
Leahy, Thomas	Chief, Product Review Branch
Pullen, George	Economist
Team 19—Agricultural Swaps and Commodity Options—DMO:	
Lachenmayr, Christa	Economist
Murray, Martin	Supervisory Economist
Team 20—Retail Forex—DCIO	(¹)
Team 21—Product Definitions—OGC:	
Kuserk, Gregory	Senior Economist
Seong, Somi	Economist
Troia, Rosario	Financial Economist
Team 22—Portfolio Margining Procedures—DCIO	(¹)
Team 23—Anti-Manipulation—ENF:	
Cusimano, Jeremy	Economic Advisor to the Director
Kass, David	Industry Economist
Team 24—Disruptive Trading Practices—ENF:	
Cusimano, Jeremy	Economic Advisor to the Director
Kass, David	Industry Economist
Team 25—Whistleblowers—ENF	(¹)
Team 26—Position Limits—DMO:	
Danger, Kenneth	Industry Economist

RULEMAKING TEAMS—Continued

Team	Title
Kass, David	Industry Economist
Littlefield, Thomas	Economist
Sherrod, Stephen	Acting Director of Market Surveillance
Outen, James	Industry Economist
Team 27—Investment Advisor Reporting—DCIO	(¹)
Team 28—Volker Rule—DCIO	(¹)
Team 29—Alternatives to Relying on Credit Ratings—OGC	(¹)
Team 30—Fair Credit Reporting Act and GLB—OGC	(¹)
Team 31—Conforming Rules—DCIO:	
Choo Lee-Ken	Industry Economist

¹ Any Economists on these teams are from the Office of the Chief Economist.

In addition, DMO is the lead staff division for eight of the rulemaking teams. The division director is Richard Shilts, who is an economist.

QUESTIONS SUBMITTED TO MARY L. SCHAPIRO

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

CREDIT RATING AGENCIES

Question. Under the Dodd-Frank regulatory reform law enacted last July, Federal agencies are required to scrub their rule books of references to credit ratings, forcing them to find alternative measures for creditworthiness.

During the credit boom, banks and other investors put great stock in the prime ratings given to mortgage bonds that later soured. The Congress was concerned that, by referencing ratings in its rules, the Federal Government may have been putting its imprimatur on the ratings.

Recently, the Securities and Exchange Commission (SEC) issued a proposed rule to eliminate references to credit ratings from the so-called “net capital rule” that requires a brokerage firm to maintain sufficient liquid assets against its proprietary securities in order to protect customers in case it fails. Currently, this rule allows brokerages to hold less capital against certain securities that hold high ratings from at least two registered credit-rating firms.

The SEC proposal would replace the former credit rating with a brokerage’s own internal assessment of the securities’ creditworthiness. This change would affect about 480 brokerages that hold proprietary securities, some of which will have to incur costs to come up with an in-house process that serves as a replacement for outside ratings.

One of your fellow Commissioners contends that this change would harm investors and force the SEC to spend more resources on its broker examinations to ensure brokerages are complying with the rules.

What mechanisms does the SEC plan to put into place to ensure that the substitute credentialing by brokerages are sound and reliable?

If the rating determination is left up to each brokerage won’t that spawn an array of varied and inconsistent standards?

Wouldn’t it be more prudent and efficient for the SEC to design an objective standard?

Answer. On April 27, 2010, the SEC proposed to remove references to credit ratings of Nationally Recognized Statistical Rating Organizations (NRSROs) in certain rules under the Securities Exchange Act of 1934, including the Commission’s net capital rule for broker-dealers.

Under the proposal, the SEC sets forth a list of factors that a broker-dealer could consider when determining the net capital treatment of preferred stock, nonconvertible debt, and commercial paper. The factors are intended to facilitate a determination by a broker-dealer as to whether a security is subject to a “minimal amount of credit risk.” If it is, the security could qualify for more favorable net capital treatment than securities of lesser credit quality. The range and type of specific factors considered would vary depending on the type of securities subject to review. A broker-dealer’s process for establishing creditworthiness and its written policies and procedures documenting that process would be subject to review in regulatory examinations by the SEC and self-regulatory organizations (SROs). A broker-dealer that does not establish, maintain, and enforce written policies and procedures rea-

sonably designed to assess creditworthiness would be subject to disciplinary action for noncompliance with the rule and could be required to recalculate its net capital.

This is not the first time the SEC has proposed to remove references to credit ratings in Commission rules. The SEC issued a concept release in 1994 on the general idea of removing references to NRSROs in its rules. In 2003, the SEC again sought comment on whether it should eliminate the NRSRO designation from Commission rules, and, if so, what alternatives could be adopted to meet the Commission's regulatory objectives. Most recently, in July 2008, the SEC made specific proposals to remove rule references to ratings by NRSROs. In response, the SEC received many comments that raised serious concerns about removing the credit rating references. In October 2009, the SEC adopted several of the proposed reference removals and re-opened for comment the remaining proposals. In each of these concept releases and rule proposals, commenters generally did not support the removal of references to NRSRO ratings from SEC rules and provided few possible regulatory alternatives.

The SEC recognizes the concerns raised by commenters that replacing credit ratings—which provide an objective benchmark—with more subjective approaches could increase costs to broker-dealers and the Commission. Accordingly, in the current proposal, the SEC seeks comment on the potential impact of moving from an objective standard to a more subjective standard and whether alternate and more reliable means of establishing creditworthiness exist.

Question. Do you think that it is possible to restore the reputation of credit rating agencies? What enhanced role does SEC play in regulating credit rating agencies?

Answer. The Dodd-Frank Act augmented the SEC's oversight authority for credit rating agencies registered as NRSROs and mandated that the Commission adopt rules in a number of areas with respect to NRSROs. The SEC began the process of implementing these mandates with the adoption of a new rule in January 2011 requiring NRSROs to provide a description of the representations, warranties, and enforcement mechanisms available to investors in an offering of asset-backed securities—as well as how those representations, warranties, and enforcement mechanisms differ from those of similar offerings. On May 18, 2011, the SEC proposed new rules and amendments to existing rules that would implement the balance of the Dodd-Frank Act's NRSRO rulemaking mandates. The proposals would enhance the SEC's existing rules governing ratings and rating agencies by, among other things, requiring NRSROs to:

- report on internal controls;
- protect against conflicts of interest;
- establish professional standards for credit analysts;
- provide public disclosure about the credit rating and methodology used to determine the credit rating, when publishing a rating; and
- enhance their public disclosures about the performance of their credit ratings.

In addition, as required by the Dodd-Frank Act, the SEC has begun conducting annual exams of NRSROs.

SEC ORGANIZATIONAL STRUCTURE STUDY

Question. In response to a directive in section 967 of the Dodd-Frank Act, the SEC retained the services of an independent consultant to analyze the Commission's structure and operation, and to suggest reforms. The Boston Consulting Group (BCG) was hired. Among the recommendations outlined in the March 10 report are that the SEC should “hire staff with high-priority skills,” “invest in technology systems,” and “improve oversight over self-regulatory organizations.”

Has the SEC evaluated the BCG findings and recommendations?

What has been the internal response to the report?

Is the SEC unified in its reaction?

What steps are being taken to address the recommendations?

What is the estimated cost of implementing the reforms the BCG recommended?

To what extent will resources made available for fiscal year 2011 be utilized to move forward with any of the changes recommended?

Although the President's fiscal year 2012 budget was submitted about 6 weeks before the BCG report, to what extent does the spending proposed for next year incorporate any aspects that would address the BCG findings?

Answer. The BCG report has provided the SEC with valuable insights into how the SEC might continue its efforts to ensure a vigilant, agile, and responsive organization. Because the scope of the BCG report's recommendations touch on virtually every aspect of the SEC's operations and offices, determining the appropriate course of action to take in response and implementing those actions will require careful internal coordination and a significant commitment of staff and other resources.

Both during the period of study by the BCG and now with regard to the final report, the SEC has been committed to the concept of this independent assessment. We welcome the opportunity to review our structure, processes, and the full range of our business operations with the goal of improving their efficiency and effectiveness to meet our mission objectives. Accordingly, I believe that the overall response within the SEC to the BCG report has been a positive one, and Commission management is unified in its commitment to excellence.

Since the report's issuance the SEC has been moving rapidly to evaluate, prioritize, and implement many of the BCG findings and recommendations. I have designated our Chief Operating Officer, Jeff Heslop, to manage the logistics of the follow-up process. We've divided the BCG recommendations into two dozen discrete work-streams, each of which has been assigned to a division or office director or other senior executive tasked to lead the follow-up work. Initially, we are analyzing the recommendations to determine whether we agree with them and, if so, to develop an implementation plan and schedule. We have also established an Executive Steering Committee to provide critical oversight, to review implementation plans, and decide how best to prioritize, sequence, and coordinate the significant follow-up work resulting from the two dozen work-streams. Further, we have established a dedicated Program Management Office that is responsible for tracking and reporting on the SEC's implementation efforts. These efforts are being funded to the extent permitted by the SEC's overall fiscal year 2011 appropriation.

In a number of cases, we are already taking follow-up actions. For instance, we have agreed with the recommendation to consolidate the functions of the Office of the Executive Director and the Office of the Chief Operating Officer and received reprogramming approval from our House and Senate Appropriations Subcommittees to take this action.

The BCG has estimated that approximately \$42 million to \$55 million in up-front costs will be required to implement the recommendations, in addition to the costs associated with the significant commitment of SEC management and staff time. A significant portion of these implementation costs (\$21 to \$28 million) would be for additional investments in information technology systems. The SEC did not have the opportunity to consider the costs of implementing the BCG recommendations in developing its fiscal year 2012 budget request, which as you note was submitted to the Congress more than a month before the SEC received the BCG's final report.

One of the key findings from the BCG report is that the SEC does not have sufficient human resources to complete the requirements of Dodd-Frank while maintaining its activities as currently performed. We would note that the BCG's estimate of the size of this staffing "capacity gap" is generally consistent with the SEC's own estimate as reflected in our fiscal year 2012 budget request. Specifically, the BCG estimates that, in fiscal year 2012, the SEC's five major divisions and examinations program collectively will experience a capacity gap of at least 400 to 450 full-time equivalent (FTE). This is consistent with our budget request for these programs for fiscal year 2012, which seeks an increase of 424 FTE for these programs compared to fiscal year 2011.¹

RESPONSIVENESS TO TIPS, COMPLAINTS, AND REFERRALS (TCRS)

Question. What has the SEC accomplished in the past year to address concerns that the Commission was historically woefully unresponsive to TCRs submitted to the Commission citing potential violations of the rules and securities laws?

Answer. In January 2010, the Division of Enforcement established the Office of Market Intelligence (OMI) to be the central intake point of all TCRs sent to the SEC by the public. The OMI has established policies, procedures, and workflow processes to analyze and research TCRs and assign out those TCRs that merit further assessment by investigative or exam staff.

Question. Are all of the incoming TCRs presently channeled to one centralized destination within the SEC for review regardless of the mode of transmission (e.g., e-mail, letter, hotline, etc.) or substantive nature of the issue?

Answer. All tips and complaints, regardless of the mode of transmission or the substantive nature of the issue, are entered into the TCR Intake and Resolution System. The system centralizes TCRs and provides work flow and audit capabilities such that all tips and complaints can be tracked from entry to disposition. With respect to referrals, we have a legacy system that we are in the process of incor-

¹The SEC's fiscal year 2012 budget seeks 424 additional FTE for the enforcement program (130); the examinations program (148); Corporation Finance (38); Trading and Markets (58), Investment Management (24); and RiskFin (26).

porating into the TCR Intake and Resolution System. As a result, referrals are not yet centralized in the TCR Intake and Resolution System.

Question. Which office within the SEC is primarily responsible for managing TCRs?

Answer. The OMI in the Division of Enforcement and the Office of Compliance Inspections and Examinations (OCIE) are the two offices within the SEC that review all TCRs. These two offices coordinate review processes to ensure that tips and complaints receive similar analysis. Investor complaints that do not concern violations of the Federal securities laws are handled by the Office of Investor Education and Assistance.

Question. Do you have an automated intake system in place at this time?

Answer. Yes. Tips and complaints can be entered by the public into the SEC's online electronic questionnaire located at www.sec.gov. The information entered automatically populates an internal database of tips and complaints—the TCR Intake and Resolution System. The public may also send tips and complaints via email, letter, or fax. Tips and complaints received by email, letter, or fax are entered by SEC staff into the same internal database of tips and complaints.

Question. Does the system track and monitor the tips?

Answer. Yes. The TCR Intake and Resolution System has the capability to track all tips and complaints from entry to disposition.

Question. Does it provide a means to link and search for multiple similar complaints against a single entity?

Answer. Yes. The TCR Intake and Resolution System has search capabilities that enable staff to link and search for similar complaints against a single entity.

Question. Does the system generate an acknowledgment to the individual or firm that submitted the TCR?

Answer. If the tip or complaint is entered through the SEC's Web site using the online questionnaire, the submitter will receive an acknowledgment of receipt as well as a reference number associated with his or her submission. If the tip or complaint is mailed or emailed, the staff will send a letter or email acknowledging receipt of the tip or complaint.

Question. That additional resources are required to further strengthen the SEC's capacity to acquire and manage an effective and functional automated TCR?

Answer. The TCR Intake and Resolution System was designed with the ability to add additional functionality such as an automated triage engine and other analytical tools. We are currently pursuing triage functionality to enhance our capabilities.

Question. To what extent does SEC management interface with your Inspector General (OIG) to cross-match complaints and tips and referrals that may be routed to each of you to identify redundancy and duplication? If that is not occurring, would doing so pose any issues?

Answer. All tips and complaints received by the SEC are required to be entered into the TCR system. Staff in the OIG will forward tips and complaints that they receive to the OMI for entry into the system. Prior to entry, the staff's protocol requires a search of the system to determine whether the tip or complaint has already been entered.

STRENGTHENING EXAMS AND OVERSIGHT—FREQUENCY OF REVIEWS

Question. A vigorous exam program serves as a vital early warning system and weakness detector.

I understand that the SEC employs a "risk-based" strategy for conducting exams of investment advisers. Under this approach, resources are concentrated on those firms and practices that have the greatest potential risk of securities law violations that can harm investors.

Your fiscal year 2012 budget justification materials indicate that the SEC examined only about 9 percent of the investment advisers in fiscal year 2010 down from 14 percent in 2008.

Is that level sufficient or acceptable, in your judgment?

What are the drawbacks of sporadic inspections of a limited universe?

What would it take to increase the number and frequency of reviews?

Does the percentage decline from fiscal year 2008 to fiscal year 2010 suggest that the SEC is reviewing fewer entities or have the number of advisers grown such that you are actually conducting more exams? (e.g., 14 percent of 1,000 = 140; 9 percent of 1,600 = 144).

Are you at least conducting initial screenings of the entire universe to identify the highest-risk ones?

Are you potentially missing some high-risk reviews because you are not able to examine 91 percent of them?

Your data also reflect that SEC exams identify deficiencies in 72 percent of the firms that are reviewed and that 42 percent of the ones with deficiencies are categorized as “significant” suggesting a high potential to cause harm or reflect recidivist conduct. It is also noteworthy that SEC intends to use more rigorous exam protocols this year and, coupled with growth in the number of regulated entities, SEC expects even lower percentages of registrants being examined.

Isn't it conceivable with new entities coming under regulatory purview that more exams are in order rather than fewer?

What resources would you need to expand exam staffing and support?

Is it possible to require more detailed and rigorous self-exams and reporting requirements imposed?

In response to the Madoff scandal and the revelation of the embarrassing ineptitude that delayed catching this criminal, what new mandates are now in place? Are SEC examiners now routinely verifying the existence of client assets in the custody of third parties, counterparties, and customers?

Answer. Current examination resources can indeed only cover a small portion of the registered investment advisers (IAs) that we are responsible for examining. Moreover, several factors are increasing the strain on our examination resources:

- increased development and use of new and complex products, including derivatives and exchange-traded funds;
- growth of technology to facilitate such activities as high-frequency trading; and
- growth of “families” of financial service firms with integrated operations that include both broker-dealer and IA affiliates.

In addition to these industry factors, the examination program now routinely verifies with third parties the assets held by IAs, an important, but labor-intensive process. As a consequence of all of these factors, fewer IA examinations were conducted in fiscal year 2010 than in fiscal year 2008, even as the population of IA registrants increased during that period.

Although we expect that, under the Dodd-Frank Act, States will assume responsibility for examining most IAs with less than \$100 million in assets under management by early 2012, the act also expanded the SEC's examination-related responsibilities to include municipal advisors, new categories of securities-based swap registrants, advisers to private funds, and other new registrants. Overall, absent any increase in resources, the expected size of the SEC-regulated community in fiscal year 2012 will dwarf the size of the current examination program to an even greater extent than is the case today.

In light of these resource constraints and in order to more effectively carry out our regulatory responsibilities, the OCIE is pursuing a more risk-based approach to the examination program. Key elements of this approach include:

- An initial screening of IAs, through the review of all Form ADV filings. We have developed a wide range of metrics to help us identify high-risk firms and improve the chances that our examination resources are focused on the right firms.
- Sharing the results of this initial risk assessment with regional offices, which add their localized knowledge of firms to develop a more refined list of high-risk firms.
- Analysis of additional sources of information, including past examinations; SEC filings; third-party information; information from other regulators; and information gathered from other examinations.
- Analysis of other risk-related information, including the size or interconnectedness of a firm; opportunities for fraud (e.g., direct access to customer funds); financial concerns about the firm; other characteristics of a firm; and the date of last exam.

Once we have selected a candidate for an examination, we will focus the scope of the examination based on a thorough understanding of the registrant's business, affiliations and potential conflicts of interest, and a high-level review of the firm's management controls and compliance systems.

For each function included in the scope of the examination, we will conduct further review of key risk management, compliance and control functions, and test selected control processes the registrant has in place to manage compliance and fraud risk. This gives us a better sense of whether the registrant has an effective “culture of compliance,” and may also encourage firms to have more rigorous compliance and self-examination programs.

While we have been working diligently to improve our exam program, we need more examiners, expertise, and further technological resources. With the addition of approximately 200 FTE positions sought in the 2012 budget, we will be able to conduct more examinations and improve our overall coverage of the industry, as well as better fulfill our new responsibilities under the Dodd-Frank Act. We also

should be able to improve our risk analysis approach so that those examinations will be more likely to focus on the areas in greatest need of attention.

The SEC recently released a staff report to the Congress on enhancing investment adviser examinations. The study, required by section 914 of the Dodd-Frank Act (914 Study), concludes that the SEC's investment adviser examination program requires a source of funding sufficiently stable to prevent examination resources from being outstripped by future growth in the number of registered advisers (i.e., that the resources are scalable to any future increase—or decrease—in the number of registered investment advisers). The 914 Study identified three options for the Congress to consider:

- Impose “user fees” on SEC-registered investment advisers that could be retained by the Commission to fund the investment adviser examination program;
- Authorize one or more SROs to examine, subject to SEC oversight, all SEC-registered investment advisers; or
- Authorize Financial Industry Regulatory Authority (FINRA) to examine dual registrants for compliance with the Advisers Act.

The SEC expressed no view as to the advisability of any of these three options.²

CIRCUIT BREAKER RULES IN RESPONSE TO MAY 2010 FLASH CRASH

Question. One year ago this week, the now notorious May 6 “flash crash” sent the Dow Jones industrial average plunging some 700 points in minutes, exposing flaws in the electronic marketplace dominated by high-speed trading.

In response, the SEC instituted new trading curbs last June as a pilot program. These single-stock circuit breakers apply to securities in the S&P 500 Index and Russell 1000 Index as well as certain exchange-traded funds.

Under the existing circuit breaker pilot, trading in a stock pauses across the U.S. equity markets for a 5-minute period if the stock experiences a 10 percent change in price over the preceding 5 minutes. The pause gives the markets the opportunity to attract new trading interest in an affected stock, establish a reasonable market price, and resume trading in a fair and orderly fashion. I understand that the circuit breaker pilot is currently set to expire on August 11, 2011.

A month ago (April 5, 2011), the SEC announced that national securities exchanges and the FINRA filed a proposal to establish a new “limit up-limit down” mechanism to address extraordinary market volatility in U.S. equity markets. If approved by the SEC, the new limit up-limit down mechanism would replace the existing single-stock circuit breakers.

This proposed “limit up-limit down” mechanism would prevent trades in listed equity securities from occurring outside of a specified price band, which would be set at a percentage level above and below the average price of the security over the immediately preceding 5-minute period. For stocks currently subject to the circuit breaker pilot, the percentage would be 5 percent, and for those not subject to the pilot, the percentage would be 10 percent.

The percentage bands would be doubled during the opening and closing periods, and broader price bands would apply to stocks priced below \$1. To accommodate more fundamental price moves, there would be a 5-minute trading pause—similar to the pause triggered by the current circuit breakers—if trading is unable to occur within the price band for more than 15 seconds.

Have the circuit breakers performed as intended? If not, why not?

Answer. One of the key purposes of the trading pauses imposed under the circuit breaker pilot was to provide an opportunity for trading interest to normalize after a stock has been subject to substantial price moves in a short period of time. In a number of instances when the circuit breakers have been triggered, the ensuing trading pause has had this intended effect. However, there may be room for improvement in terms of the actual mechanism that is used to guard against excessive volatility. In particular, because the circuit breakers are triggered only after a trade occurs outside of the applicable percentage threshold, there has been a propensity for the circuit breakers to be triggered by erroneous trades.

Question. What advantages or improvements do you expect to gain by replacing the circuit breakers with the limit up/limit down mechanism?

Answer. In contrast to the single-stock circuit breaker, which may be triggered by an erroneous trade, a limit up-limit down mechanism, which would prevent trades in individual securities from occurring outside of a specified price band, would help to prevent erroneous trades from occurring in the first place.

²Commissioner Walters issued a separate statement in which she supported the second option—authorizing an SRO to oversee investment advisers. See <http://www.sec.gov/news/speech/2011/spch011911ebw.pdf>.

In addition, unlike the single-stock circuit breaker, the limit up-limit down mechanism will feature a 15-second “limit state” that is triggered before a trading pause may be initiated. Once triggered, the market for that security may exit the limit state in 1 of 2 ways. If the quotation that triggered the limit state (i.e., an offer at the lower price band, or a bid at the upper price band) is either cancelled or executed against in its entirety, the market for that security will exit the limit state and return to regular trading. If the quote is not cancelled or executed against in its entirety, then a trading pause is initiated for that stock once the 15-second period has run. In instances where the limit state was triggered by an erroneous quote or a momentary gap in liquidity, as opposed to a more fundamental price move, the “limit state” feature thus allows the market to quickly correct itself by cancelling or executing against the quotation that triggered the limit state, allowing regular trading to resume instead of automatically initiating a trading pause.

Question. What’s the timetable for action on the limit up/limit down proposal?

Answer. The proposed limit up-limit down National Market System (NMS) Plan was published in the Federal Register on June 1, 2011, and the 120-day period for SEC approval ends on September 29, 2011 (although the period for approval or disapproval may be extended to 180 days). If the SEC approves the plan, the plan participants have proposed that the initial date of plan operations be 120 days following publication of the approval order in the Federal Register. In particular, plan participants proposed that once the plan is operational, it will be implemented in two phases. Phase I will be launched on the initial date of plan operations, and will cover stocks in the S&P 500, the Russell 1000, and a list of select exchange-traded products. Phase II of the plan, which will apply to all remaining NMS securities, will be implemented 6 months thereafter.

MARKET MAKER QUOTING OBLIGATIONS

Question. What other initiatives or market structure measures has the SEC pursued in response to the flash crash?

Answer. One of the phenomena that occurred on May 6, 2010 was that trades were executed at irrational prices as low as one penny or as high as \$100,000. These trades occurred as a result of so-called “stub quotes”, which are quotes generated by market makers (or the exchanges on their behalf) at levels far away from the current market in order to fulfill continuous two-sided quoting obligations even when a market maker has withdrawn from active trading. In the following months, the SROs filed, and the SEC approved, proposals establishing minimum quoting obligations for market makers. Specifically, for stocks that are in the S&P 500, Russell 1000, and a select list of exchange-traded products, market makers must submit a quote for one round lot of shares at 8 percent away from the National Best Bid or Offer (NBBO) between the hours of 9:45 a.m. and 3:35 a.m. For quotes in these securities that are submitted between 9:30 and 9:45 a.m., and between 3:35 and 4 p.m., this quoting obligation changes to 20 percent away from the NBBO. For securities that are not included in the S&P 500, Russell 1000, or the select list of exchange-traded products, market makers must submit a quote at 30 percent away from the NBBO.

In connection with the recently filed proposals to extend the single-stock circuit breaker pilot to all remaining NMS securities, using either a 30 percent threshold (for securities in that group that are trading at or above \$1) or a 50 percent threshold (for securities in that group that are trading below \$1), the SROs proposed corresponding changes to the market maker quoting obligations. If those proposals are approved, market makers would be obligated to quote one round lot at 28 percent away from the NBBO for those securities trading at or above \$1 (and thus subject to the 30 percent circuit breaker threshold), and 30 percent away from the NBBO for those securities trading below \$1 (and thus subject to the 50 percent circuit breaker threshold).

In each of these cases, a market maker’s quote may “drift” an additional 1.5 percent away from the NBBO before a new quote within the applicable band must be entered.

CLEARLY ERRONEOUS PILOT PROGRAM

Another initiative following May 6 was the approval of a pilot program establishing uniform clearly erroneous standards. To provide market participants more certainty as to which trades will be broken and allow them to better manage their risks, the national securities exchanges and FINRA proposed new trade break procedures, which were approved by the SEC on a pilot basis in September 2010.

These rules clarified the process for breaking erroneous trades. The rules will make it clearer when, and at what prices, trades will be broken by the exchanges

and FINRA. Specifically, for stocks that are subject to the circuit breaker program, trades are broken at specified levels depending on the stock price:

- For stocks priced \$25 or less, trades are broken if the trades are at least 10 percent away from the circuit breaker trigger price.
- For stocks priced more than \$25 to \$50, trades are broken if they are 5 percent away from the circuit breaker trigger price.
- For stocks priced more than \$50, trades are broken if they are 3 percent away from the circuit breaker trigger price.

Where circuit breakers are not applicable, the exchanges and FINRA will break trades at specified levels for events involving multiple stocks depending on how many stocks are involved:

- For events involving between 5 and 20 stocks, trades are broken that are at least 10 percent away from the “reference price,” typically the last sale before pricing was disrupted.
- For events involving more than 20 stocks, trades are broken that are at least 30 percent away from the reference price.

On May 6, the markets only broke trades that were more than 60 percent away from the reference price in a process that was not transparent to market participants. By establishing clear and transparent standards for breaking erroneous trades, the new rules help to provide clarity in advance as to which trades will be broken, and allow market participants to better manage their risks.

Other Initiatives

Revision of the Market-wide Circuit Breakers.—The SEC is working with the Commodity Futures Trading Commission (CFTC), as well as with the securities and futures exchanges, to develop a framework for SRO rule proposals to implement changes to the current market-wide circuit breakers originally implemented in 1988 (and last revised in 1998). The goal is to modify these circuit breakers to better address the type of volatility experienced on May 6, 2010, and to better conform with today’s market structures and trading dynamics.

Expansion of the Circuit Breaker Pilot To Cover all NMS Securities.—On May 6, 2011, the SROs filed proposed rule changes to extend the single-stock circuit breaker pilot program to all remaining NMS securities. The triggering percentage would be 30 percent for securities in this group that are trading at or above \$1, and 50 percent for securities in this group that are trading below \$1. Absent the SEC extending the timeframe, the deadline for approving or disapproving these filings is June 26, 2011.

Market Access Rules.—The compliance date for Rule 15c3–5, which imposes restrictions on sponsored and direct market access, is July 14, 2011, although some market participants have requested a short extension of the compliance date for some aspects of the rule. This rule contains regulatory risk management procedures that may assist in reducing erroneous trades.

Other Initiatives.—The SEC continues to consider the recommendations made by the Joint CFTC–SEC Advisory Committee on Emerging Regulatory Issues in its Summary Report. The SEC also continues to work toward implementing a consolidated audit trail for the U.S. equity market.

Question. What lessons were learned as a result of May 6, 2010?

Answer. From the extreme price movements observed on May 6, a number of key lessons emerged. One key lesson is that under stressed market conditions, the automated execution of a large sell order can trigger extreme price movements, especially if the automated execution algorithm does not take prices into account. Moreover, the interaction between automated execution programs and algorithmic trading strategies can quickly erode liquidity and result in disorderly markets. As the events of May 6 demonstrate, especially in times of significant volatility, high-trading volume is not necessarily a reliable indicator of market liquidity.

May 6 was also an important reminder of the inter-connectedness of our derivatives and securities markets, particularly with respect to index products. The nature of the cross-market trading activity was confirmed by extensive interviews with market participants, many of whom are active in both the futures and cash markets in the ordinary course, particularly with respect to “price discovery” products such as the E-Mini and SPY.

Another key lesson from May 6 is that many market participants employ their own versions of a trading pause—either generally or in particular products—based on different combinations of market signals. While the withdrawal of a single participant may not significantly impact the entire market, a liquidity crisis can develop if many market participants withdraw at the same time. This, in turn, can lead to the breakdown of a fair and orderly price-discovery process, and in the extreme case trades can be executed at stub-quotes used by market makers to fulfill their contin-

uous two-sided quoting obligations. As demonstrated by the CME's Stop Logic Functionality that triggered a halt in E-Mini trading, pausing a market can be an effective way of providing time for market participants to reassess their strategies, for algorithms to reset their parameters, and for an orderly market to be re-established.

A further observation from May 6 is that market participants' uncertainty about when trades will be broken can affect their trading strategies and willingness to provide liquidity. In fact, in interviews with staff of the SEC, many participants expressed concern that, on May 6, the exchanges and FINRA only broke trades that were more than 60 percent away from the applicable reference price, and did so using a process that was not transparent.

Finally, the events of May 6 clearly demonstrate the importance of data in today's world of fully-automated trading strategies and systems. This is further complicated by the many sources of data that must be aggregated in order to form a complete picture of the markets upon which decisions to trade can be based. Varied data conventions, differing methods of communication, the sheer volume of quotes, orders, and trades produced each second, and even inherent time lags based on the laws of physics add yet more complexity. Whether trading decisions are based on human judgment or a computer algorithm, and whether trades occur once a minute or thousands of times each second, fair and orderly markets require that the standard for robust, accessible, and timely market data be set quite high. Although the SEC and CFTC staff did not believe that significant market data delays were the primary factor in causing the events of May 6, the analyses of that day reveal the extent to which the actions of market participants can be influenced by uncertainty about, or delays in, market data.

IT WEAKNESSES

Question. Today, there is no standardized, automated system to collect data across the various trading venues, products, and market participants. Each market has its own individual and often incomplete data collection system, and as a result, regulators tracking suspicious activity or reconstructing an unusual event must obtain and merge an immense volume of disparate data from a number of different markets. And even then, the data does not always reveal who traded which security, and when.

To obtain individual trader information, the SEC must make a series of manual requests that can take days or even weeks to fulfill. In brief, the SEC's tools for collecting data and surveilling our markets are wholly inadequate to the task of overseeing the largest equity markets in the world.

How can we get a handle on this situation?

What kind of system is needed?

Have there been cost estimates of what it would take to create and deploy such a system?

Answer. As you noted, there currently is no standardized, automated system to collect order and trading data across the various trading venues and market participants. To track suspicious activity or to reconstruct an unusual event in the marketplace such as last year's May 6 market disruption, regulatory staff at the SEC, the exchanges and FINRA currently must merge an immense volume of disparate data from a number of different markets and often must make a series of manual requests, a process that can take days or even months to complete.

In order to address this situation, in May 2010, the SEC proposed a rule to require the exchanges and FINRA to create and implement a consolidated audit trail that would electronically capture customer and order information for all orders for equities and options, across all markets, for the entire life of an order. Under the proposal, the SEC and the SROs would have access to consolidated audit trail data for surveillance and other regulatory purposes. I believe that this consolidated audit trail would enhance the ability of the SEC and the SROs to detect and assess potentially illegal activity.

The estimated costs, as well as the estimated benefits, are discussed in the SEC release proposing the consolidated audit trail. Most of the costs for the creation and implementation of the consolidated audit trail would be borne by the industry. However, I anticipate that the SEC would need to incur costs in order to make full use of the consolidated audit trail. For example, SEC staff would need the technology infrastructure to access and run analyses on the consolidated audit trail data. If the SEC approves the consolidated audit trail proposal, I expect that a portion of our fiscal year 2012 budget will be used to begin to develop the Commission's capacity to use the information to be collected by such an audit trail.

Does your proposal to spend \$78 million (about 5.5 percent) of the \$1.407 billion budget you are seeking for fiscal year 2012 include initiatives to address these IT deficiencies?

Answer. In addition to the Consolidated Audit Trail, the proposal to spend \$78 million for fiscal year 2012 also includes some initiatives to address the SEC's IT deficiencies; however, most of the SEC's IT infrastructure and security deficiencies are planned to be addressed through initiatives from the fiscal year 2011 budget and process improvements.

Question. I note that the CFTC is proposing to devote 21 percent of its proposed \$307 million fiscal year 2012 budget to information technology enhancements? What is your view on whether devoting a mere 5 percent to IT is sufficient given the circumstances?

Answer. The budget request for the CFTC would dedicate 21 percent of its fiscal year 2012 budget to information technology, both for operations and maintenance and for enhancements. For the SEC, the equivalent figure for technology spending in fiscal year 2012 would be about 12 percent of its requested appropriation. When combined with expected technology spending out of the SEC's Reserve Fund, the total percentage is 14 percent. We believe this amount would be sufficient to continue modernizing the SEC's technology environment and advance key initiatives, such as the TCR system; the migration of our financial system to a Federal Shared Service Provider (SSP); the Consolidated Audit Trail system; EDGAR and SEC.gov modernization; and Dodd-Frank Act deployments.

TACKLING MATERIAL WEAKNESSES IN INTERNAL CONTROLS

Question. A Government Accountability Office (GAO) audit of the SEC's November 2010 Performance and Accountability Report identified two material weaknesses in internal controls over financial reporting: one in information systems, and a second in financial reporting and accounting processes.

These are not new findings, but have been identified by the GAO in several previous audits. Chairman Schapiro, I note that you fully and freely acknowledge these material weaknesses are unacceptable.

I understand that the SEC has decided to invest the time and resources to implement a long-term, comprehensive solution. Instead of creating new technology and systems, the SEC is switching to a SSP approach, migrating the SEC's financial system to the Department of Transportation (DOT).

Other agencies, including the GAO, have migrated to the DOT, and they have experienced very positive results, with clean audits free of material weaknesses. This will be a significant undertaking, which, assuming adequate funding, will culminate in the cutover to the new system in April 2012.

What do you estimate it will cost to migrate to a SSP?

Will the plan involve annual payments to the DOT for providing the service?

What will it save in the long run?

Are you planning to take steps immediately using fiscal year 2011 resources to prepare for the transition?

Answer. In its fiscal year 2010 financial audit of the SEC, the GAO found that the SEC's financial statements were presented fairly, in all material respects, and in conformity with U.S. generally accepted accounting principles. The GAO noted two material weaknesses: one in information systems and a second in financial reporting and accounting processes. You correctly note that I find these material weaknesses to be unacceptable.

The SEC is working this fiscal year on a number of fronts to correct the deficiencies noted by the GAO. In order to make its internal controls strong and sustainable over the long term, the SEC has decided to move its financial system and transaction processing to a Federal SSP, the DOT's Enterprise Services Center. After a planning phase was completed in January 2011, the implementation phase of the project began in February 2011 and will culminate in the cutover to the new system in April 2012.

The total budget for the initial deployment, including for the design and setup of the system and the conversion of the SEC's data, is \$25 million, of which the SEC will need about \$12 million in fiscal year 2011 and \$13 million in fiscal year 2012. Once the SEC cuts over to the DOT's financial system, the SEC will make annual payments for operations and maintenance, equal to about \$5.5 million per year. Although the SEC did not undertake this initiative primarily for cost savings, the SEC does expect that its ongoing, annual costs will be lowered by about \$1.4 million per year after the migration.

BROKER DEALER AND INVESTMENT ADVISERS STANDARDS OF CONDUCT

Question. Brokers and dealers and investment advisers have been held to different standards of conduct in their dealings with investors. In very general terms, a broker-dealer is held to a suitability standard, and an investment adviser is held to a fiduciary duty standard.

The “suitability” standard requires that brokers and dealers assess their customers’ knowledge of securities and their financial situations and recommend securities that are suitable for their customers. Courts have imposed on a fiduciary an affirmative duty of “utmost good faith, and full and fair disclosure of all material facts,” as well as an affirmative obligation “to employ reasonable care to avoid misleading” one’s clients.

Section 913 of the Dodd-Frank Act entitled “Study and Rulemaking regarding Obligations of Brokers, Dealers, and Investment Advisers,” is the major provision setting out a new approach for defining standards of conduct for these financial industry professionals. It requires the SEC to conduct a study to evaluate the effectiveness of the current legal or regulatory standards of care for brokers, dealers, and investment advisers and whether there are legal gaps, shortcomings, or overlaps in the standards, and enumerates 14 areas of consideration for this study.

Has this study been conducted? If not, when do you expect it to commence and conclude?

Answer. Yes, the study required under section 913 (“Study on Investment Advisers and Broker-Dealers”) was completed and submitted to the Congress in January 2011.

Question. Chairman Schapiro, do you believe that when investors receive similar services from similar financial service providers that those providers—irrespective of their particular title—should be held to the same standard of conduct?

Answer. Yes, I believe that when investors receive similar services from similar financial service providers, they should receive similar protections—regardless of the label applied to that financial service provider. As the staff’s Study on Investment Advisers and Broker-Dealers notes, we know that the difference between an investment adviser and a broker-dealer is often lost on an investor. What remains difficult to justify is why there should be different rules and standards of conduct for the two roles—especially when the same or substantially similar services are being provided.

 QUESTIONS SUBMITTED BY SENATOR BEN NELSON

Question. I understand the financial crisis raised a number of concerns about municipal securities markets. However, I believe the Securities and Exchange Commission’s (SEC) proposed rule to require municipal advisors to register with the SEC goes too far.

While I do think that professional financial advisors should be registered, appointed members of municipal entities, like the ones I appointed in Nebraska as Governor, should not have to register as “municipal advisors.”

In Nebraska these citizens are appointed by elected officials and are held accountable by those officials. I don’t believe the registration process is relevant to the activities of a public utility board or the members of a State educational finance authority’s board.

Do you anticipate modifications to the final rule that would clarify that appointed members of municipal entities, like elected members, are considered “municipal employees” and are therefore excluded from the definition of a municipal advisor?

Answer. As you know, on December 20, 2010, the SEC proposed for public comment rules that would govern the registration of municipal advisors and, among other things, proposed guidance and solicited comments on the appropriate treatment of appointed members of a governing body. We have received approximately 1,000 comment letters on the proposal, including many that address this important issue, and we are reviewing them carefully.

Section 15B(e)(4)(a) of the Securities Exchange Act, as added by the Dodd-Frank Act, provides that the term “municipal advisor” includes a person (who is not a municipal entity or an employee of a municipal entity) that “provides advice to or on behalf of a municipal entity or obligated person with respect to a municipal financial product or the issuance of municipal securities.” Accordingly, our proposal would only require nonemployee-appointed officials, such as board members of local public entities, to register if they provide advice with respect to a municipal financial product or an issuance of municipal securities to or on behalf of a municipal entity or obligated person, or if they undertake a solicitation of a municipal entity.

Public input is critically important to us in crafting rules. We will certainly give the comments we have received on this issue careful consideration before adopting a final rule.

Question. In the current fiscal climate we are faced with many difficult decisions when it comes to the budget.

While we were able to increase SEC funding by \$74 million more than the fiscal year 2010 enacted level of \$1.111 billion in the continuing resolution, I anticipate that providing additional funding in fiscal year 2012 will be even more difficult.

Can you speak to the impact on the SEC's ability to regulate markets and enforce securities laws if we are only able to maintain fiscal year 2011 levels in fiscal year 2012?

What would the impact be if the SEC were funded at fiscal year 2008 levels or the level the House recently passed in their fiscal year 2012 budget proposal?

Answer. We greatly appreciate the subcommittee's strong support in recent years. The additional \$74 million provided in fiscal year 2011 will allow the SEC to fill vacancies to meet key strategic needs, begin to perform some of the agency's new responsibilities, and continue to improve agency operations.

For fiscal year 2012, it is first important to note that the SEC's budget will be fully offset by matching collections of fees on securities transactions. Thus, the SEC's fiscal year 2012 appropriation at any level would have no direct impact on the deficit.

In addition, as I stated in my testimony, it is important to note that over the last 20 years, the SEC's budget and workforce have fallen far behind the growth in the size and complexity of the securities markets. During that time, the average value of securities transactions per day has risen by about 2,500 percent and the value of investment adviser assets has grown by about 3,070 percent. Although the SEC's workforce grew over this period, it did not nearly keep pace. This mismatch between the changes in the markets and in the SEC has been exacerbated since 2005. Between 2005 and 2007, the SEC's workforce and technology investments had to be cut back, and they are only now returning to 2005 levels. In 2005, the SEC's funding was sufficient to provide 19 examiners for each \$1 trillion in investment adviser assets under management. Now that figure stands at 12 examiners per \$1 trillion.

Today, the SEC has responsibility for approximately 35,000 entities, including direct oversight of 11,800 investment advisers, 7,500 mutual funds, and more than 5,000 broker-dealers with more than 160,000 branch offices. We also review the disclosures and financial statements of approximately 10,000 reporting companies. The SEC also oversees approximately 500 transfer agents, 15 national securities exchanges, 9 clearing agencies, 10 Nationally Recognized Statistical Rating Organizations, as well as the Public Company Accounting Oversight Board, Financial Industry Regulatory Authority, Municipal Securities Rulemaking Board, and the Securities Investor Protection Corporation. In addition, last year the SEC received vast new or enhanced responsibilities to oversee derivatives, hedge fund advisers, municipal advisors, and credit rating agencies.

The Boston Consulting Group's (BCG) study, mandated by section 967 of the act, concluded that although there are opportunities for redirecting resources to the agency's top priorities, the SEC still faces a "capacity gap" and needs significantly more staffing resources to effectively carry out its responsibilities. The BCG study estimated that this gap in fiscal year 2012 is equal to 400–450 additional staff in the agency's five divisions and Office of Compliance Inspections and Examinations, in line with the President's fiscal year 2012 request.

Keeping the SEC's fiscal year 2012 funding at the fiscal year 2011 appropriated level of \$1.185 billion would have serious consequences for the SEC. The agency would be unable to hire expertise in new areas such as derivatives, hedge fund advisers, credit rating agencies, and others. The agency also would be unable to fulfill strategic staffing needs in our long-standing core programs, such as for enforcement investigations, investment adviser examinations, and enhanced reviews of disclosure filings of large companies. In addition, the SEC would face reductions in the technology investments needed to strengthen operations and effectively oversee the markets, at a time when technology is more important to the markets than ever before, and when the firms the SEC regulates annually spend many times more on technology than the entire SEC budget.

Cutting the agency's fiscal year 2012 funding to the levels of fiscal year 2008 would be devastating. If the SEC were to receive an fiscal year 2012 appropriation reflecting its fiscal year 2008 level, reflecting the overall approach taken in the House's fiscal year 2012 budget proposal, the agency's funding would be \$906 million, or \$279 million less than our fiscal year 2011 appropriation—a 24 percent reduction. A reduction of this magnitude would make significant cuts in staff and IT

unavoidable and would undoubtedly dismantle most of the important achievements of the past 2 years to make the SEC more vigilant, agile, and responsive.

Under this scenario, the SEC would need to take dramatic action to cut its workforce. Even after factoring in projected attrition, a 24 percent cut in the Commission's budget would require a personnel reduction of approximately 1,120 additional FTE—nearly one-third of our workforce. To achieve this reduction through a RIF alone would require eliminating 1,760 positions outright. A furlough to achieve this reduction would have to cover the entire SEC workforce for approximately 85 workdays. The most dramatic impact would inevitably be on the largest programs—enforcement, examinations, and disclosure review.

If the SEC were to cut IT investments to achieve a 24 percent reduction in the overall agency budget, the impact would be immediate and damaging. For example, the SEC would have to eliminate all new IT investments and suspend all ongoing development work on IT systems. Major technology initiatives would have to be halted, such as those to track tips, complaints, and referrals; strengthen the agency's financial controls; enhance enforcement and examination management systems; and bolster data analytics capabilities.

QUESTIONS SUBMITTED BY SENATOR THAD COCHRAN

Question. You mention recent challenges the Securities and Exchange Commission (SEC) faced in maintaining staffing levels and budgets sufficient to carry out its core mission. Following its investigation of Stanford Financial, the Office of the Inspector General (OIG) identified several problems at the SEC. However, none of these problems involved inadequate funding or inadequate staffing. This year the agency reorganized its national examination program in part as a response to lessons learned from the Stanford fraud. What changes did you make in this reorganization to ensure the problems identified by the OIG are being corrected?

Answer. While the Stanford IG Report did not include recommendations directed to the Office of Compliance Inspections and Examinations (OCIE), its findings show a clear need for improved coordination between enforcement and the OCIE on investigations of potential violations of the Federal securities laws, particularly those investigations initiated by a referral from the OCIE to the Enforcement Division. The OCIE has undertaken specific policy changes in its National Examination Program and instituted procedures to improve coordination and communication between the Enforcement Division and the OCIE.

Through a number of structural and process reforms, the OCIE and the Enforcement Division are working to identify misconduct earlier and to move to shut it down more rapidly. The OCIE and enforcement staff and leadership have been directed to evaluate potential referrals from the OCIE exam staff against enforcement's programmatic priorities regularly and determine the disposition of referrals. If there is disagreement on a case at the regional level, exam staff has been instructed to escalate the matter to the attention of senior leadership in Washington. These processes ensure that concerns can be escalated in a timely manner to senior leadership of both the exam and enforcement programs for appropriate review and resolution.

Exam and enforcement coordination with respect to particular matters is also the subject of periodic reviews. The OCIE policy now requires that the OCIE exam staff in each office hold quarterly Exam Reviews, in which the progress and status of every exam in the office is discussed and evaluated for several factors, including evaluating any significant issues with the firm that is the subject of the exam, determining whether more staff resources are needed on the exam and deciding if the exam is a potential referral to the Enforcement Division. These reviews are an opportunity to summarize and preview findings that appear likely to trigger possible Enforcement referrals, as well as to flag any potential differences in the assessment of urgency, potential harm to investors, or other issues that can then be raised at the joint regional meetings or to the OCIE senior management.

Finally, the OCIE exam staff is working closely with Enforcement's specialized units to identify key risks presented by entities registered with the SEC and key risks to the markets. As previously described, this partnership with the specialized units has already resulted in new approaches to joint efforts to identify risky firms that may warrant examination or an enforcement investigation. In addition, the OCIE recently announced the creation of several specialized working groups that will focus on areas where the OCIE plans to increase its specialization and market knowledge.

We have recently received encouraging news about these reforms. On March 30, 2011, the OIG issued the OCIE Regional Offices' Referrals to Enforcement, Report

No. 493 (Referral IG Report). This audit report suggests that our efforts at improved coordination are meeting with success. The report notes that a survey of all the OCIE examiners throughout the SEC's regional offices concerning their view of Enforcement responses to examination-related referrals found that "when combining the responses for 'completely satisfied' and 'somewhat satisfied' for respondents, the majority of SEC regional offices had a combined level of satisfaction ranging from 70 to 87 per cent." The IG Report further found that where there was dissatisfaction with the referral process, the level of concern dramatically dropped over time and particularly in fiscal year 2010, with some respondents identifying enforcement's newly created Asset Management Unit as having significantly assisted with the acceptance rate of the OCIE referrals.

An additional issue raised by the OIG's Stanford report, albeit one for which there were no specific recommendations, was a relative lack of coordination between the investment adviser exam team and the broker-dealer exam team in the Fort Worth Regional Office's examinations of Stanford. Senior leadership of the National Examination Program recognizes that the past structure within the examination program has resulted in certain silo effects in the examination process. After giving this issue careful consideration, changes have been made to the structure of several regional offices. For example, some of the regional offices have restructured their examination program so that each subgroup contains both adviser examiners and broker-dealer examiners. These examiners report to the same immediate supervisor, which has strengthened collaboration in examining entities that are dually registered with the SEC as both an investment adviser and a broker-dealer such as Stanford.

Question. I am very troubled by the OIG's report, released last year, on Stanford Financial. Many Mississippians and other Americans lost their life savings by investing in what were freely marketed as safe, Certificate-of-Deposit investments. Dating back to 1997, the SEC's Fort Worth Examination Group repeatedly requested that an enforcement action be brought against Stanford Financial. That was more than 12 years before the SEC actually brought an enforcement action. The OIG found serious managerial, cultural, and performance-based problems at the SEC, which led to this terrible failure. What are you doing to help compensate the victims of the Stanford Financial fraud?

Answer. We are proceeding on several fronts. Most recently, on June 15, 2011, the SEC asked the Securities Investor Protection Corporation (SIPC) to initiate a court proceeding under the Securities Investors Protection Act (SIPA) to liquidate the broker-dealer. This decision was based on the totality of facts and circumstances in the case. A SIPA liquidation proceeding would allow investors with accounts at Stanford Group Company to file claims with a trustee selected by the SIPC.

On the litigation front, the SEC's focus is to hold wrongdoers accountable while providing maximum recovery available under the law to investors harmed by this egregious fraud. First, after filing its civil action in February 2009, the SEC filed a motion requesting that the district court appoint a receiver over the defendants' assets to prevent waste and dissipation of those assets to the detriment of investors. Second, to complement the receiver's efforts, the SEC, in coordination with the Department of Justice (DOJ), moved to freeze Securities and Investment Board assets held in international financial institutions. Freezing assets in international jurisdictions poses complex litigation challenges, but this step was crucial to ensure the protection of investor funds. Third, the SEC is working with the receiver, DOJ, and securities regulators and law enforcement agencies in the United Kingdom, Switzerland, Canada, Mexico, and in several countries throughout Central and South America, to identify, secure, and repatriate for the benefit of investors more than \$300 million in cash and securities held in non-U.S. bank accounts.

In a status report filed February 11, 2011, the receiver identified several categories of major assets for possible distribution to harmed investors:

- \$94.7 million in cash on hand;
- \$30.4 million in private equity investments already recovered and liquidated;
- \$1 million in coins and bullion inventory;
- \$6 million in real estate sale proceeds, with an additional \$11.7 million expected from sales of other identified properties; and
- \$594.9 million in pending fraudulent transfer and unjust enrichment claims.¹

In conjunction with the SEC, the receiver is focused on identifying and liquidating the largest possible pool of obtainable assets for distribution to harmed investors.

The SEC is closely monitoring the receiver's costs to ensure optimal recovery for the victims of this massive fraud. We have strongly urged the receiver to stringently apply a cost-benefit analysis and pursue only those legal claims that could generate

¹ This figure includes amounts claimed in lawsuits filed or intended to be filed by the receiver; actual recovery may vary depending on litigation outcome.

maximum proceeds for the benefit of investors while minimizing the receiver's legal fees and expenses. We also have cautioned the receiver that we are carefully scrutinizing all bills requesting payment for fees and expenses. In fact, on at least three occasions, the SEC has formally challenged the receiver's bills. We will continue to do so where appropriate.

QUESTIONS SUBMITTED BY SENATOR KAY BAILEY HUTCHISON

Question. The Madoff and Stanford Ponzi schemes represent what many view as two of the largest failures of the Securities and Exchange Commission (SEC). Investigative reports published by your own Inspector General (OIG) highlighted several areas where the SEC failed in its mandate to protect investors. Can you please explain how the additional funds you are requesting for fiscal year 2012 would have helped the SEC to prevent or respond better to shut down the Madoff or Stanford Ponzi schemes before thousands of American investors saw their finances so devastated?

Answer. The SEC commends the work of the OIG investigating this matter and drafting the reports, Investigation of the SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme, OIG-526 (Stanford IG Report) and Investigation of the SEC's Failure to Uncover Bernie Madoff's Ponzi Scheme, OIG-509 (Madoff IG Report). In the Stanford IG Report, the OIG conducted an extensive investigation that clearly identifies missed opportunities for protecting investors, and no one should evade responsibility for the SEC's handling of the Stanford matter. We deeply regret that the SEC failed to act more quickly to limit the tragic investor losses suffered by Stanford's victims. In the Madoff IG Report, the OIG identified numerous red flags that the SEC missed in its examinations and investigation of Bernie Madoff's hedge fund and trading practices.

In particular, the Stanford IG Report, which was released last year, made important recommendations identifying areas for improvement throughout the SEC and both the Division of Enforcement and the Office of Compliance Inspections and Examinations (OCIE) have since instituted various measures to implement all of those recommendations.

In addition to the OIG's recommendations in the Stanford IG Report, under their new leadership both the Division of Enforcement and the OCIE have engaged in a top to bottom review within the last 2 years and have implemented measures to reform organizational processes and improve our effectiveness. We have streamlined management; put seasoned investigative attorneys back on the front lines; improved our examiners' risk-assessment techniques; revised our enforcement and examination procedures to improve coordination and information-sharing; leveraged the knowledge of third parties; instituted new initiatives to identify fraud; expanded our training programs; hired staff with new skill sets; and revamped the way that we handle the tremendous volume of tips, complaints, and referrals that we receive annually.

Although our reform efforts are ongoing, the OIG's recent report, the OCIE Regional Offices' Referrals to Enforcement, Report No. 493 (Referral IG Report), issued on March 30, 2011, indicates that enhanced coordination between Enforcement and the OCIE is proving effective, particularly in the area of handling referrals from the OCIE to Enforcement. In addition, strengthened collaboration between the OCIE and Enforcement has resulted in a number of notable enforcement actions in the past 2 years.

Despite the many changes, more work remains. This will require commitment and creativity. While we must always efficiently use existing resources, additional resources will help us continue to implement organizational reforms underway in the Division of Enforcement and the OCIE. For example, additional resources will allow us to enhance our IT capabilities to allow enhanced data analytics and data mining in our Enforcement investigations, enabling us to identify patterns across suspicious conduct and generate meaningful investigative leads. Although we deeply regret the losses suffered by Stanford and Madoff investors, we embrace the challenges that lie ahead and are confident that our ongoing efforts will enhance investor protection and the integrity of our financial markets.

Question. The Securities Investors Protection Act (SIPA) Trustee appointed to the Madoff case has reportedly recovered almost all the investors' original principal to be distributed among the victims, while the SEC-appointed receiver in the Stanford case has so far recovered an estimated 2 cents per \$1. Unlike the Securities Investor Protection Corporation (SIPC) appointed trustee who draws his fees from the SIPC, the SEC-appointed receiver draws his fees from the funds he has been able to recover. Ultimately, this lessens funds able to be distributed to Stanford investors.

Does the SEC still maintain that receivership was the appropriate course of action for the Stanford case? If so, why?

Answer. Upon filing its civil action in February 2009, the SEC filed a motion requesting that the district court appoint a receiver over the defendants' assets (including more than 100 Stanford-related entities operating around the world) to prevent waste and dissipation of those assets to the detriment of investors. While a receiver was a necessary tool in this case, the SEC has closely monitored the receivership to help maximize investor recovery. To complement the receiver's efforts, the SEC, in coordination with the Justice Department, moved to secure assets held in international financial institutions.

Securing assets in international jurisdictions poses complex litigation challenges, and those challenges have been magnified in this case by, among other issues, the appointment in Antigua of a competing receiver that has not cooperated with the SEC and that, in fact, has challenged various steps taken by the receiver, the SEC and the Justice Department. But securing international assets was crucial to ensure the protection of investor funds and we continue to work closely with the receiver, Justice Department, and securities regulators and law enforcement agencies in the United Kingdom, Switzerland, Canada, Mexico, and in several countries throughout Central and South America, to identify, secure, and repatriate for the benefit of investors more than \$300 million in cash and securities held in non-U.S. bank accounts.

In conjunction with the SEC, the receiver is focused on identifying and liquidating the largest possible pools of assets to prepare for a future distribution to harmed investors. In addition, the SEC has recently worked with other involved parties in the creation of an investor committee to provide an additional mechanism for investor input as to the receivership operations.

Throughout this case, the SEC has worked closely with a court-appointed examiner to monitor the receiver's costs and ensure maximum recovery to the victims of this massive fraud. These efforts have had tangible benefits. For example, the receiver and the professionals assisting him have reduced their customary fees by at least 20 percent and have capped the rates charged by senior lawyers. In addition, we carefully scrutinize the receiver's bills for fees and expenses. In fact, in response to our objections, the district court has held back, on an ongoing basis, an additional 20 percent from the receiver's fees and expenses. We have strongly urged the receiver to stringently apply a cost-benefit analysis and pursue only those legal claims that could generate maximum proceeds for the benefit of investors while minimizing the receiver's legal fees and expenses.

As with our monitoring of the receiver's fees and expenses, the SEC has intervened when it believed the receiver was pursuing inappropriate claims. For example, the SEC challenged the receiver's lawsuits seeking net profits from innocent investors. Conversely, when the receiver properly pursues assets, we intervene in support of that effort where appropriate. For example, the SEC recently submitted an amicus brief in the Fifth Circuit supporting the receiver's efforts to maintain a freeze more than approximately \$24 million in accounts held by former Stanford financial advisers. We will continue to be closely involved with the receiver's activities.

Question. Currently, the Supreme Court forbids investors from going to court to compel SIPC to order a brokerage liquidation as it believes there are adequate safeguards in place to prevent a miscarriage of justice for investors. What options do investors have when they do not agree with the SEC's or the SIPC's interpretation of the SIPA?

Answer. The SEC staff monitor situations in which SIPC member broker-dealers are in (or may be approaching) financial distress to determine whether a SIPA liquidation proceeding is appropriate for the protection of the firm's customers. In addition, customers of SIPC member firms and their representatives can and do communicate with SEC staff and Commissioners when they believe that a member firm should be liquidated under the SIPA. In the Stanford case, for example, investors asked the SEC to direct SIPC to begin a liquidation under the SIPA of Stanford Group Company, a registered broker-dealer and member of SIPC. On June 15, 2011, the SEC asked SIPC to initiate a court proceeding under the SIPA to liquidate Stanford Group Company. In every case in which the SEC has concluded that a SIPC member firm should be liquidated under the SIPA, SIPC has agreed to do so. If SIPC were not to agree, section 11(b) of SIPA gives the SEC the right to file an action to compel SIPC to begin a liquidation proceeding to ensure that the protections provided by SIPA are available to the customers of the SIPC member firm. The SEC has authorized its Division of Enforcement to bring an action to compel SIPC to begin a SIPA liquidation of Stanford Group Company if SIPC refuses to do so.

In *Securities Investor Protection Corporation v. Barbour*, 421 U.S. 412 (1975), the Supreme Court held that customers of a SIPC member firm do not have an implied private right under SIPA to ask a court to require SIPC to begin a liquidation proceeding. Without deciding whether customers may challenge the SEC's decision not to seek an order (under SIPA section 11(b)) compelling SIPC to begin a liquidation proceeding, the Court in *Barbour* noted that the SEC's brief in that case indicated that such a decision "might be reviewable under the Administrative Procedure Act for an abuse of discretion." *Id.* at 425 n.7. No customer has sought judicial review of an SEC decision not to request a court to order SIPC to begin a SIPA liquidation.

QUESTION SUBMITTED BY SENATOR MARK KIRK

Question. Last year, the Congress passed significant new sanctions on Iran and others, including the United Nations and the European Union, also imposed sanctions. The result is that companies continuing to do business in Iran now face significantly more risk—the risk of direct sanctions; the risk that sanctions will make any business in Iran more difficult and more expensive; and the representational risk that comes with doing business with a regime that brutally suppresses its own people. Why has the Securities and Exchange Commission (SEC) failed to issue a specific regulation requiring companies, which face potential sanction under U.S. law for their activity in Iran, to disclose that information?

Answer. Currently, our rules do not include a line-item requirement to disclose a company's business activities in Iran. Instead, with regard to whether companies will be required to disclose information relating to activities in Iran, the general materiality analysis that governs disclosure obligations applies. Under our rules, a company would be required to provide some disclosure of its business activities in Iran if the company faces material risks, including material risks from possible sanctions violations, as a result of those activities. Generally speaking, information is considered material if there is a substantial likelihood that a reasonable investor would consider it important in deciding how to vote or make an investment decision, or, put another way, if the information would alter the total mix of available information. I recognize that this is a difficult judgment call, and may not result in disclosure in every case that some may think is appropriate.

I note, however, that I have asked the Division of Corporation Finance to prepare a rule proposal for the SEC's consideration on disclosure of activities that may subject a company to sanctions under the Iran Sanctions Act. In addition, based on a study of divestment activities, the Government Accountability Office has recommended that the SEC consider issuing a rule requiring companies that trade on U.S. exchanges to disclose their business operations tied to Sudan, as well as possibly other state sponsors of terrorism. The division has outlined the terms for a possible rule proposal for specific disclosure requirements regarding business and investment activities in Iran and Sudan, and has circulated this outline for the SEC's consideration.

SUBCOMMITTEE RECESS

Senator LAUTENBERG. The subcommittee hearing is hereby recessed.

[Whereupon, at 11:22 a.m., Wednesday, May 4, the subcommittee was recessed, to reconvene subject to the call of the Chair.]

MATERIAL SUBMITTED SUBSEQUENT TO THE HEARING

[CLERK'S NOTE.—The following testimonies were received subsequent to the hearing for inclusion in the record.]

PREPARED STATEMENT OF ENTERPRISE COMPLIANCE INTERNATIONAL

This writing follows our review of the Senate Appropriations Subcommittee on Financial Services and General Government hearing (May 4) deliberating another increase for the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC). What we heard in this subcommittee hearing pretty much echoed the comments of House Capital Markets and Government Sponsored Enterprises Subcommittee members who challenged the increase because these agencies are “bloated” and “over lawyered”. Instead of getting into the politics, we supplied a solution to all of these problems—and that solution called for no increases at all; in fact, with the proper attention paid to the “culture”¹ within these agencies, we are able to make each and every one of these agencies self-sustaining.

This is a synopsis and value proposition of benefits available to the SEC given use of Enterprise Compliance International's Renaissance Excalibur Cost-Containment Package (RECCP)—which has been forwarded to the respective chairs of the Financial Services Committee and its House Capital Markets and Government Sponsored Enterprises Subcommittee, plus Ways and Means ranking member Representative Charles B. Rangel.

RECCP was developed exclusively for use by the SEC to remove wasteful, inefficient, and outdated regulatory programs, as espoused by Representative Spencer Bachus and his House Capital Markets and Government Sponsored Enterprises subcommittee chairman Representative Scott Garrett.

Please take notice that this management package requires a one-time \$25 million investment in return for which it will remove at least \$100 million per annum in program costs (paying for RECCP in 90 days or less). Continued use of RECCP will not only cut SEC program costs but will allow the agency to operate independent of taxpayer funded budgeting.

At a very nominal monthly usage fee, the SEC (like the CFTC) will sustain itself.

If we continue to delay remedies, the SEC will realize a \$200 million net operating loss by fiscal year 2015 which will essentially shut the agency down. All of this is avoidable by funding RECCP as soon as possible. The \$222 million increase now sought by Chairman Schapiro will barely cover this shortfall; ergo, we cannot solve these problems with more money, the culture is flawed and must include what can be done from within each agency to make it self-sustaining without giving our taxpayers the bill for shortsighted agency management.

At the time of this writing (5/4/2011, 11:15 a.m. CDT), our national debt is \$14.349347 trillion and rising.

We seek immediate dialogue with Chairman Dick Durbin and Ranking member Jerry Moran.

PREPARED STATEMENT OF THE INVESTMENT COMPANY INSTITUTE

The Investment Company Institute (ICI)¹ appreciates this opportunity to submit testimony to the subcommittee relating to the administration's fiscal year 2012 ap-

¹ Excerpted from a statement Congressman Brad Sherman.

¹ The ICI is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$13.1 trillion and serve more than 90 million shareholders.

proprations request for the Securities and Exchange Commission (SEC). In the past, the subcommittee has consistently sought to provide adequate resources for the SEC. For the reasons expressed below, we urge it to do so again this year.

IMPORTANCE OF A WELL-FUNDED AND EFFECTIVE SECURITIES REGULATOR

Registered investment companies (RICs)² and their shareholders have a strong stake in an effective SEC. RICs are one of America's primary savings and investment vehicles for middle-income Americans. All told, more than 91 million shareholders in more than 52 million U.S. households owned some type of registered fund in 2010.³ At year-end 2010, total RIC assets were approximately \$13 trillion. These funds, and their millions of investors, benefit when the SEC conducts sound rule-making and effective oversight.

RICs are an integral part of our economy in another way, as well. In addition to their role as the investment vehicle of choice for millions of Americans, investment companies have been among the largest investors in the domestic financial markets for much of the past 15 years and held a significant portion of the outstanding shares of U.S.-issued stocks, bonds, and money market securities at year-end 2010.⁴ Indeed, investment companies as a whole were one of the largest groups of investors in U.S. companies, holding 27 percent of their outstanding stock at year-end 2010.⁵ As major participants in the stock, bond, and money markets, RICs and their shareholders benefit from strong regulatory oversight of these markets.

STAFFING AND DODD-FRANK IMPLEMENTATION

The Congress is rightly concerned about Government spending. It also must be concerned that the SEC not lack resources it needs to successfully pursue its investor protection and market oversight functions, including the new responsibilities assigned to the agency by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

While we have no view on the specific levels of funding and staffing necessary for the SEC, we recognize that the new responsibilities assigned to the SEC by Dodd-Frank are substantial and will call for significant resources.⁶ These responsibilities include expanded regulatory authority over derivatives trading, hedge fund advisers, and municipal advisors. While expanding the SEC's authority in these areas is important to fill significant regulatory gaps, it should not come at the risk of impairing the SEC's pre-existing responsibilities with respect to mutual funds and other more "traditional" products, nor compromising the interests of their millions of mainstream investors.

In particular, we believe more can and should be done to develop the SEC's economic research and analytical capabilities. There is a compelling need for the SEC to better inform itself about its regulated industry and market, as well as the economic consequences of its regulations. This is imperative if the SEC is to avoid regulatory approaches that could have the effect of making financial firms or products less competitive, less innovative, less attractive to talented professionals, and less available to investors.

IMPROVEMENTS IN THE USE OF AVAILABLE RESOURCES

No matter what level of funding ultimately is authorized, it is vitally important that the SEC utilize the resources it has to their maximum effect. Chairman Schapiro is to be commended for taking significant steps over the past few years to improve the operational efficiency of the SEC, bringing in new leadership and senior management in many of the agency's divisions, restructuring some key divisions, seeking to improve the agency's risk assessment capabilities, and hiring more staff with specialized expertise and real world experience, among other things. Still, Chairman Schapiro herself admits that much work remains to improve the SEC's

²Fund sponsors offer four types of registered investment companies in the U.S.—open-end investment companies (commonly called "mutual funds"), closed-end investment companies, exchange-traded funds (ETFs), and unit investment trusts (UITs).

³Michael Bogdan, John Sabelhaus & Daniel Schrass, *Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet, 2010*, Investment Company Institute Fundamentals 19, no. 6 (September), available at <http://www.ici.org/pdf/fm-v19n6.pdf>.

⁴Investment Company Institute, *Investment Company Fact Book* (51st ed. 2011). The Fact Book is available at <http://www.icifactbook.org>.

⁵*Id.*

⁶The SEC argues that it will need to add 468 positions to implement Dodd-Frank. See Congressional Justification fiscal year 2012 in Brief, at p. 3, available at <http://www.sec.gov/about/secfy12congbudget.pdf>.

internal operations.⁷ We strongly agree. We therefore strongly support the continued focus on internal reforms that will allow the SEC to work more efficiently and improve its performance. This includes, for example, conducting empirical research that informs major rulemakings, providing regulatory guidance that reflects a better understanding of the relevant regulated industry, better integrating activities of different SEC divisions and branch offices, and implementing new inspection strategies.⁸ The SEC also will have a tremendous amount of new data as a result of recent rulemakings, such as data from Form N-MFP (relating to money market funds) and proposed Form PF (relating to private funds). It should have adequate funding to acquire and implement the technology necessary to understand, utilize, and secure all of this data.

CONCLUSION

The Congress must assure that the SEC has resources sufficient to adequately fund its staffing and to take other steps to fulfill its mission of protecting the Nation's investors, including more than 91 million investors who own mutual funds and other registered investment companies, and that it deploys those resources to the best possible effect. These investors deserve the benefits of an SEC that can soundly, effectively, and efficiently regulate securities offerings, market participants, and the markets themselves. American taxpayers deserve every assurance that the SEC, indeed all agencies and departments of Government, husband their resources appropriately.

Accordingly, we urge the Congress to provide the appropriations necessary to allow the SEC to appropriately fulfill its mission.

We appreciate your consideration of our views.

⁷See Testimony on Implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act by the U.S. Securities and Exchange Commission Before the United States Senate Committee on Banking, Housing, and Urban Affairs, Thursday, February 17, 2011.

⁸We also note that section 967 of Dodd-Frank directed the SEC to engage the services of an independent consultant to study a number of specific areas of SEC internal operations. That organizational study, by the Boston Consulting Group, was delivered to Congress on March 10. It is available at <http://www.sec.gov/news/studies/2011/967study.pdf>.

FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2012

WEDNESDAY, MAY 25, 2011

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 10 a.m., in room SD-138, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.
Present: Senators Durbin, Moran, and Kirk.

SMALL BUSINESS ADMINISTRATION

STATEMENT OF HON. KAREN G. MILLS, ADMINISTRATOR, SMALL BUSINESS ADMINISTRATION

OPENING STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. Good morning. I'm pleased to convene this hearing of the Appropriations Subcommittee on Financial Services and General Government. Today we're going to examine funding provided for small business and community development programs under our jurisdiction.

I welcome my Ranking Member, Senator Jerry Moran of Kansas. And other colleagues may join us during the course of the hearing.

Also, we welcome the Small Business Administrator, Karen G. Mills and the Director of the Department of the Treasury's Community Development Financial Institutions Fund (CDFI), Donna J. Gambrell. I'll welcome the second panel of witnesses in short order.

In the face of recent pressure to reduce the deficit, we have tried to focus on those programs which make a difference and have an impact on communities. I have supported the Small Business Administration (SBA) and the CDFI Fund programs because I think they produce real outcomes. But, we continue to ask the hard questions and demand proof that is what is actually happening.

For the SBA for fiscal year 2011, we were able to maintain funding at the 2010 level, despite the need to make some painful cuts in other parts of the budget. Put simply, small businesses, we believe, are the key to economic recovery. Small businesses create nearly 2 out of every 3 new jobs, employ one-half the Nation's private sector workforce, and generate 44 percent of private payroll. The SBA has been on the front line of this economic crisis, working to help small business owners. Small businesses have faced some difficulty gaining access to capital, and turned to the SBA for help.

The SBA oversees a loan portfolio of \$85 billion and, in a typical year, makes or guarantees more than \$20 billion in loans.

On our second panel, Mr. Warner Cruz will tell us about how the SBA helped his small business not only stay afloat during the credit crisis, but also helped him to make a major expansion of the business, including a renovation of an abandoned building in Rolling Meadows, Illinois. Mr. Cruz's business, restoring damaged homes and businesses from flooding, fires, and storms—unfortunately, for the people who were owners, but fortunately for him—is now flourishing with 85 full-time staff and many part-time staffers.

SBA programs also supported counseling services for budding entrepreneurs and small business owners. I'm concerned about proposed cuts in those programs, which we'll talk about during the hearing.

The budget request for 2012 for the SBA is \$985 million. Now, that's a \$256 million, or 35 percent, increase in the current level. I said to my staff when they said that to me, "Can you be honestly realistic about that? A 35 percent increase in 1 year, in light of what we're going through?" Much of the funding has become necessary for the SBA Business Loan Program and disaster loan programs to stay operational. Some of it reflects accounting realities, which we'll get into here. We'll talk about those.

The CDFI Fund for fiscal year 2011 is provided \$227 million. I placed a high priority on maintaining investment in this fund because of its unique ability to leverage private sector investment in community development, like affordable housing, retail development, and community centers, as well as lending to small businesses. Federal grants for the CDFI Fund have never been earmarked for specific projects. Instead, the Treasury makes competitive grants that can best demonstrate a capacity to help communities.

With just a small amount of seed funding, the CDFI Fund can transform communities. Nationwide, the CDFI Fund leverages an average of \$13 for every Federal \$1 invested. In 2010, Federal grants helped to create or maintain more than 80,000 jobs. I've got quite a bit of information here about the impact of the CDFI Fund. I visited the King Legacy Apartments in a tough part of Chicago which used to be a vacant, pretty ugly lot—you get to see it here in before and after photos. I can tell you, from driving through the area surrounding it, that this really made a difference in terms of people's attitudes toward their community, toward their neighborhood. And let me show one other example of a CDFI Fund investment in Illinois—before-and-after pictures of Wilson Yard, a major project in Chicago's uptown area. It was built on the site of a former rail yard and is now a mixed-use development. And you'll see, off to the right, a huge Target store, which took over that vacant lot, along with other businesses. And of course, former Mayor Daley's pride and joy, rooftop greenery. We have a lot of that in Chicago. We're very proud of it. And the CDFI Fund helped to make that a reality.



King Legacy Apartments area—before.



King Legacy Apartments—after.



Wilson Yard—before.



Wilson Yard—after.

Senator DURBIN. On our second panel, we're going to hear, after we've listened to the testimony of our two first witnesses, from Warner Cruz, whom I mentioned earlier—he was the Illinois small business person of the year for 2010 and an SBA borrower; Calvin Holmes, president of the Chicago Community Loan Fund who will tell us about the impact of the CDFI Fund in Illinois; and Ray Moncrief, from Kentucky Highlands, an investment corporation based in London, Kentucky, will talk about participating in the CDFI Fund and the SBA microloan program.

And at this point, I want to turn it over to my colleague Senator Moran, who told me he had three hearings at 9:30 a.m. and made this one a priority.

Thank you.

STATEMENT OF SENATOR JERRY MORAN

Senator MORAN. Mr. Chairman, thank you very much.

I've already instructed my staff that next year we're going to have visuals, as well. You have upped the ante. Although, I doubt any of ours will show greenery on the rooftops.

I thank you for calling this hearing. And I welcome our witnesses. Nice to see both of you, and I look forward to your testimony.

The American economy is facing many difficult challenges, and we need to get our country moving again. It seems to me, in two aspects of getting our financial house in order, moving toward balancing the budget, reducing our deficit spending is an important priority. At the same time, we need to grow our economy. And we need to make certain that the opportunities are there for small business and entrepreneurs to succeed.

And so, while much of the discussion in the Congress today is about reduced spending—and I support that effort—there's also another, in fact, perhaps more enjoyable way of helping us reduce our deficit, and that's putting people to work. And so, I'm particularly interested in finding the right balance with your agencies to see that we don't spend money that we shouldn't be spending, that we don't—that we're not inefficient or waste money. But, I also want to make certain that the tools are there for business to grow to succeed and, in the process of pursuing that success, put lots of Americans to work and put food on families' tables.

So, I look forward to hearing your testimony.

One of the things, Ms. Mills, that I'm particularly interested in is the role in regard to disasters. I just returned from Kansas over the weekend—Reading, Kansas—saw the tornado damage there; a small town of about 270 folks with half the homes destroyed. As a Member of the House of Representatives, I represented Greensburg, Kansas, a town totally destroyed by an F5 tornado, in which the SBA played a significant role in helping for recovery. And of course, Kansans, and all Americans, extend their sympathies and concerns to the people of Joplin and places across our country that have experienced tremendous storm damage. And so, I am interested in hearing your thoughts about your appropriations request, particularly as they relate to weather-related disasters that we're currently experiencing.

And again, Mr. Chairman, thank you for the opportunity. I look forward to hearing the testimony.

Senator DURBIN. Thank you, Senator.

Both of our witnesses will have 5 minutes each for an opening statement. Administrator Mills, please start.

SUMMARY STATEMENT OF KAREN G. MILLS

Ms. MILLS. Thank you. Chairman Durbin, Ranking Member Moran, and members of the subcommittee, I'm very pleased to be testifying before the subcommittee.

Small businesses, as the Senators have just described, are the backbone of our economy. They create 2 out of every 3 jobs, and more than one-half of working Americans own or work for a small business.

The SBA is a small agency, but we have a big mission. We put the maximum possible resources directly into the hands of small businesses, focusing on access to capital, contracts, counseling, and disaster assistance. Last year, we helped more than 50,000 small businesses get capital to grow and hire. We put about \$100 billion in Federal contracts get into the hands of small businesses. We counseled more than 1 million small businesses in every State across the country. And as we speak, as the Senator from Kansas mentioned, SBA employees are on the ground, in Missouri, Kansas, Alabama, and elsewhere, assisting victims of the disasters, including some deployment that we just did overnight, to Oklahoma, where there were additional tornados.

This is the worst tornado season, as you know, in nearly six decades. We are there to help homeowners, renters, and business owners with long-term, low-interest loans. And even if a business wasn't damaged directly, but the customers are suffering and not coming into the business, the SBA can help with business interruption loans.

We're doing this efficiently. The turnaround times for disaster applications are about 10 days. After Hurricane Katrina, they were about 70 days. So, we're down from 70 days to 10 days.

We put these resources into the hands of small businesses while providing the taxpayers a big bang for their buck. For example, after credit froze in 2008, the American Recovery and Reinvestment Act (ARRA) and the Small Business Jobs Act allowed us to support more than \$42 billion of SBA loan guarantees into the hands of small business, at a subsidy cost of \$1.2 billion. Many small businesses suffered greatly from the recession, and our job is to support them as they grow and create jobs.

This job is not done. The President's proposed fiscal year 2012 budget for the SBA of \$985 million will support up to \$27 billion in loan guarantees, as well as many other tools and resources to help small businesses across the country. At the same time, the budget reflects a commitment to tighten our belts, streamline our processes, and eliminate duplication. This includes ideas from the Congress. For example, we looked hard at our technical assistance programs to be sure that each one was unique and nonduplicative. As a result, we proposed eliminating the Program for Investment in Micro-Entrepreneurs program. With the work of our micro-lenders and new efforts to recruit community-based lenders, which

you will hear more about today, we can continue to provide technical assistance in a more cost-effective way.

The largest increase in our budget, that the Senator referred to, reflects the fact that we have reached the statutory limit for fees that we can assess. The budget reflects the need for additional subsidy because losses, including those from loans approved when collateral, such as real estate was inflated, have pushed up subsidy costs. We will also request a legislative fix to return to near zero subsidy. The budget also builds on our strong efforts over the past 2 years to remove fraud, waste, and abuse in our contracting programs. And it supports the new women's contracting program. I know that both of these issues are a high priority for many Members of Congress.

PREPARED STATEMENT

Overall, our priorities are twofold. We have placed a focus on the SBA programs that put money and support directly into the hands of small business owners in the places where they live. And we will continue to invest in oversight to preserve the integrity of these programs and to protect the interest of taxpayers.

I look forward to working with you to ensure that small businesses can continue to grow, create jobs, and lead us to a full recovery.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF KAREN G. MILLS

Chairman Durbin, Ranking Member Moran, and members of the subcommittee. I'm pleased to testify before the subcommittee.

Small businesses are the backbone of our economy. They create nearly 2 of every 3 new jobs. And more than one-half of working Americans either own or work for a small business.

The Small Business Administration (SBA) is a small agency, but we have a big mission. We put the maximum possible resources directly into the hands of small business, focusing on access to capital, contracts, counseling, and disaster assistance.

Last year, we helped more than 50,000 small businesses get the capital to grow and hire. We helped put about \$100 billion in Federal contracts in the hands of small businesses. And we counseled more than 1 million small businesses in every State across the country.

As we speak, SBA employees are on the ground in Missouri, Kansas, Alabama, and elsewhere, assisting the victims of disasters, including those suffering after the worst tornado season in nearly six decades. We are there to help homeowners, renters, and business owners with long-term, low-interest loans. Even if a business wasn't damaged directly, but customers are suffering and not coming in to the store, SBA can help with business interruption loans.

And we're doing this efficiently. Turnaround times for disaster loan applications are about 10 days, down from about 70 days in the weeks after Hurricane Katrina.

We put these resources in the hands of small business while providing taxpayers a big bang for their buck. For example, after credit froze in 2008, the American Recovery and Reinvestment Act and the Small Business Jobs Act supported more than \$42 billion in SBA loans at a subsidy cost of \$1.2 billion.

Many small businesses suffered greatly from the recession. Our job is to support them as they grow and create jobs. This job is not done.

The President's proposed fiscal year 2012 budget of for the SBA of \$985 million will support up to \$27 billion in loan guarantees as well as many other tools and resources to help our country's small businesses. At the same time, this budget reflects a commitment to tighten our belts, streamline our processes, and eliminate duplication. This includes ideas from the Congress.

For example, we looked hard at our technical assistance programs to be sure each was unique and nonduplicative. As a result, we propose eliminating the Program

for Investment in Micro-Entrepreneurs program. With the work of our microlenders and new efforts to recruit community-based lenders, we can continue to provide technical assistance in a more cost-effective way.

The largest increase in this budget reflects that we have reached the statutory limit for fees that we can assess. This budget reflects the need for additional subsidy because losses—including those from loans approved when collateral such as real estate was inflated—have pushed up subsidy costs. We will also request a legislative fix to return to near zero-subsidy.

The budget also builds on our strong efforts over the past 2 years to remove waste, fraud, and abuse in Federal contracting. And it supports the new women's contracting program. I know that both of these issues are a high priority for many Members of Congress.

Overall, our priorities are twofold. We have placed a focus on SBA programs that put money and support directly into the hands of small business owners, in the places they live. And, we will continue to invest in oversight to preserve the integrity of these programs and to protect the interest of taxpayers.

I look forward to working with all of you to ensure that small businesses can continue to grow, create jobs, and lead us into full recovery.

Senator DURBIN. Thank you, Administrator.
Director Gambrell, your turn.

DEPARTMENT OF THE TREASURY

COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS FUND

STATEMENT OF DONNA J. GAMBRELL, DIRECTOR

Ms. GAMBRELL. Good morning, Chairman Durbin, Ranking Member Moran, and distinguished members of the Senate Appropriations Subcommittee on Financial Services and General Government. Thank you for inviting me to speak today about the CDFI Fund's fiscal year 2012 budget request and the critical ways in which the CDFI Fund is creating jobs and transforming low-income communities across this country.

I've been Director of the CDFI Fund for more than 3 years, during a time when our Nation has endured the most turbulent economy in generations. The financial crisis has had far-reaching consequences for our country, but nowhere has there been a more detrimental impact than on our low-income communities. My principal role as Director is to ensure that the CDFI Fund is doing everything possible to alleviate the economic burden on those at-risk communities, primarily through support of CDFIs.

There are now almost 1,000 certified CDFIs across the Nation serving every State. These CDFIs take a variety of forms, including loan funds, credit unions, community banks, and venture capital funds. They serve local, regional, and even national markets to spur economic and community development in distressed areas, at the grassroots level.

CDFIs have pioneered new financial education initiatives, encouraged the development of green industries in rural manufacturing, and invested in transit-oriented developments, charter schools, healthcare centers, and community facilities. And they've created thousands of jobs through the steady support of entrepreneurs and small businesses.

As a vital component of the Treasury Department, the CDFI Fund closely aligns itself with the Treasury's core priority of strengthening economic growth through its support of CDFIs. The CDFI Fund's programs are designed to generate a maximum economic benefit to low-income communities with a minimum Federal cost.

On average, a CDFI Fund awardee will take their initial grant and use it to attract private investment by a factor of 13. This unique ability will enable CDFIs to generate more than \$1 billion worth of investment stemming from the \$105 million in CDFI Program awards that I announced last year.

Through strategic and targeted private and local partnerships, CDFIs have achieved remarkable success with their CDFI Fund grants. In fiscal year 2010, CDFI Fund awardees created or maintained more than 80,000 jobs, almost 30,000 of which were a direct result of new loans and investments. Awardees reported financing

more than 12,000 businesses and nearly 6,000 affordable housing units and provided financial literacy and other training to 140,000 individuals. The CDFI Fund is critical to maintaining the growth of a strong community development finance industry, an industry that will make long-lasting and continual impacts across the Nation.

CDFI Fund programs are consistently oversubscribed. For example, in this current round of the CDFI Fund program, 393 applicants requested almost \$500 million when only \$145 million is available. Due to this high demand, we've been forced to cap our rewards at lower levels in order to provide grants to as many highly qualified applicants as possible. The strong and continuous demand for CDFI Fund awards and the proven impact that these awards make and the capacity of CDFIs to increase loans, investments, and financial services in low-income and distressed communities, demonstrate that it's essential to fully appropriate the President's fiscal year 2012 budget request for the CDFI Fund.

The President's request guarantees our ability to continue our valuable programs, including the CDFI Program's Financial and Technical Assistance Awards, the Healthy Food Financing Initiative, and our successful and much needed Native Initiatives. This request also includes funding for the new Bank on USA initiative and administrative requirements. Through the administration of these programs, the CDFI Fund will continue to serve our Nation's lowest-income communities.

PREPARED STATEMENT

The CDFI Fund has seen considerable support from this subcommittee in recent years for program development and appropriations. My deepest thanks go to its members and to Chairman Durbin for your unwavering confidence in the CDFI Fund and our important mission.

Thank you. And I look forward to taking your questions.
[The statement follows:]

PREPARED STATEMENT OF DONNA J. GAMBRELL

INTRODUCTION

Good morning Chairman Durbin, Ranking Member Moran, and the distinguished members of the Senate Appropriations Subcommittee on Financial Services and General Government. My name is Donna J. Gambrell and I am the Director of the Department of the Treasury's Community Development Financial Institutions (CDFI) Fund. Thank you for inviting me to speak today about the CDFI Fund's fiscal year 2012 budget request and the critical ways in which the CDFI Fund is promoting economic development efforts throughout the country.

I would like to start by expressing my deep appreciation to this subcommittee and to the Congress for its long history of support. The CDFI Fund's programs stimulate the economy in communities often considered too risky for mainstream financial institutions. CDFIs are strategically positioned to help some of the most vulnerable populations in the Nation at a time when they are facing many financially challenging situations. CDFIs are often the only source of financing in underserved communities. CDFIs support productive small businesses, affordable housing for low-income Americans, high-quality community facilities, and provide retail banking services to the un-banked and others often targeted by predatory lenders.

I have been Director of the CDFI Fund for more than 3 years, during a time when our Nation has endured the greatest recession in generations. The recession has had far-reaching consequences for our entire Nation, but nowhere has there been a more detrimental impact than on distressed and low-income communities. Many of these

same communities were already suffering before the financial crisis, and their recovery will now take much longer than in other parts of the country.

My principal role as Director is to ensure that the CDFI Fund is doing everything possible to alleviate the economic burden on low-income communities, primarily through support of CDFIs and other institutions that focus their efforts on serving these at-risk communities.

CDFIs are financial institutions that take a variety of forms—they are loan funds, credit unions, community banks, and venture capital funds. They are local, regional, and even national organizations that spur economic and community development in distressed areas from a grassroots level. CDFIs, as a class of financial institutions, have years of experience providing financial products and credit counseling services that permit borrowers to enter into and participate successfully in the financial mainstream. CDFIs fill a critical gap in the financial industry—they serve target markets that are historically underserved and they provide economic development services for niche areas that require specialization. The CDFI Fund encourages the growth and capacity of this valuable industry through a strategic deployment of resources.

THE CDFI FUND'S ROLE

The United States Congress established the CDFI Fund as a bipartisan initiative under the Riegle Community Development and Regulatory Improvement Act of 1994 (Public Law 103–325). Recognizing the need to bolster a fledgling industry that was making significant inroads in economic development in low-income communities, the bill's authors designed the CDFI Fund to provide financial and technical support to CDFIs with the goal of improving economic conditions in low-income neighborhoods across the country. The mission of the CDFI Fund is to increase economic opportunity and promote community development investments for underserved populations and in distressed communities in the United States.

As a vital component of the Department of the Treasury, the CDFI Fund closely aligns itself with the Treasury's core priority of strengthening economic growth. The CDFI Fund's programs are designed to generate a maximum economic benefit to low-income communities with a minimum Federal cost.

It begins with CDFI certification. To be certified as a CDFI by the Treasury Department, organizations are required to meet a strict set of criteria, including having a primary mission of community development, as well as serving a target market that meets at least one of the CDFI Fund's definitions of a distressed or low-income community. One common type of target market is a Census tract that has a poverty rate of at least 20 percent, or an unemployment rate 1.5 times the national average, or a median family income at or below 80 percent of the statewide or metropolitan average.¹ As organizations must be certified as CDFIs in order to be eligible for funding under many of the CDFI Fund's programs, the certification criteria allow the Treasury to verify that awards are going to the neighborhoods that need them the most. Almost 200 CDFIs were certified or recertified in fiscal year 2010 alone, and as of April 2011 there are 949 certified CDFIs across the Nation and the United States territories.

Once certified, the most common way for a CDFI to participate in the CDFI Fund's programs is through our core program, the CDFI Program. The CDFI Program provides Financial Assistance and Technical Assistance awards to qualified CDFIs. These awards are intended as seed money to attract more private capital

¹In order to become certified, an organization must submit a CDFI certification application to the CDFI Fund for review and approval. The application must demonstrate that it meets each of the following requirements:

- Be a legal entity at the time of certification application;
- Have a primary mission of promoting community development;
- Be a financing entity;
- Primarily serve one or more target markets;
- Provide development services in conjunction with its financing activities;
- Maintain accountability to its defined target market; and
- Be a nongovernment entity and not be under control of any government entity (tribal governments excluded).

An eligible target market may consist of an:

- Investment Area*.—A geographic unit or contiguous geographic units that have a poverty rate of at least 20 percent; or an unemployment rate 1.5 times the national average; or a median family income at or below 80 percent of the statewide/metropolitan average; or is wholly located within an Empowerment Zone or Enterprise Community; or
- Low-income Targeted Population*.—A geographic unit comprised of individuals whose median family income is at or below 80 percent of the statewide/metropolitan average; or
- Other Targeted Population*.—An identifiable group of individuals who lack adequate access to capital and have been historically denied credit.

into CDFIs and their investments in distressed communities. The awards also allow CDFIs to leverage resources to increase the size of their service area and to build their own internal capacity so that they can better serve their target markets.

Demand for CDFI program awards has significantly increased over the years. For the fiscal year 2011 award round, the CDFI Fund received 393 applications from CDFIs requesting a total of almost \$465.9 million in assistance, nearly three times the \$169.7 million available. Because of the continual high demand coupled with limited resources, the CDFI Fund capped the maximum award at \$1 million in fiscal year 2009, and even lower at \$750,000, in fiscal year 2010.

Another CDFI Fund program, Native Initiatives, also continually faces demand well beyond its available resources. Native Initiatives provides Financial Assistance awards, Technical Assistance grants, and training to Native CDFIs and other Native entities proposing to become or create Native CDFIs. Through the Native American CDFI Assistance Program (NACA program) demand for financial and technical assistance continues to grow at a rate that eclipses available resources. In fiscal year 2011, the CDFI Fund received more applications than ever in the history of the NACA program, receiving 88 applications requesting \$35 million—a 48 percent increase more than the \$23.7 million requested in fiscal year 2010. Such an increase in demand demonstrates that Native Initiatives is successfully reaching and building the lending capacity in communities that have lacked such capabilities until now.

The CDFI program and Native Initiatives are complemented by efforts to provide technical assistance and training to CDFIs. First, is Native Initiatives' "Economic Developments in Indian Country" workshops, co-sponsored by the Federal Reserve Bank of San Francisco, Seattle branch. The 2010 workshop series featured presentations by four other Federal development agencies, and allowed the participants to network and brainstorm solutions to economic development difficulties in Native communities.² Forty percent of the fiscal year 2011 NACA program applicants attended at least one of the workshop sessions in 2010.

Second, the CDFI Fund's Capacity Building Initiative provides support to all forms of CDFIs in areas of key business practices or economic development interests. The Capacity Building Initiative was designed based upon input received from CDFIs nationwide to significantly boost the ability of CDFIs to deliver financial products and services to underserved communities. The initiative has already had a phenomenal response from the industry. CDFIs have demonstrated a demand for the initial four capacity-building training and technical assistance tracks, which will allow them to build their own internal capacity and expand their expertise in key areas currently affecting the communities they serve, such as affordable housing, business lending, and providing financing for healthy food activities. In addition to training, the CDFI Fund has also commissioned a research project to review CDFI coverage in distressed communities across the Nation, which will allow CDFIs to determine where low-income communities are lacking access to CDFI services.

One of the key drivers of the Capacity Building Initiative is that innovation and a nimble response to changing economic conditions are stalwart traits of the CDFI industry. CDFIs have demonstrated these traits time and time again during the uncertain economy of recent years.

The CDFI Fund also administers other programs in support of community and economic development. The Bank Enterprise Award Program (BEA program) rewards banks for completing community development investments in eligible census tracts. To date, the CDFI Fund has made more than \$336 million in awards under this program, supporting increases in investments in CDFIs and low-income communities across the Nation. Beginning in the fiscal year 2009 funding round, the CDFI Fund required that all BEA awardees use their BEA awards for future CDFI support and community development activities, as defined under the BEA program regulations. Awardees that receive awards more than \$50,000 are required to report to the CDFI Fund on how the award was deployed.

No overview of the CDFI Fund's programs would be complete without the New Markets Tax Credit program (NMTC program), although it does not fall under the purview of this subcommittee. The NMTC program attracts investment capital to low-income communities by permitting individual and corporate investors to receive a tax credit against their Federal income tax return in exchange for making equity investments in Community Development Entities (CDEs). CDEs in turn make loans and investments in businesses and real estate projects in low-income communities.

²The other Federal agency participants in the 2010 Economic Development in Indian country workshops were the Department of Commerce, the Department of the Interior's Office of Indian Energy and Economic Development, the Small Business Administration, and the Department of Agriculture, Rural Development.

CDEs must apply for the authority to issue New Markets Tax Credits to their investors. In any given application round, requests are generally 7 to 8 times higher than the available allocation authority. To date, NMTC investors have invested more than \$20 billion into low-income, urban, and rural communities throughout the United States, approximately two-thirds of which has been invested in communities characterized by severe economic distress—census tracts with a poverty rate of 30 percent or with a median income at or below 60 percent of the area median family income.

IMPACT OF CDFIS

CDFIs serve distressed and low-income communities through innovation, specialization, and targeted services. The customers of certified CDFIs, on average, are 70 percent low income, 60 percent minority, and 52 percent female. These traditionally underserved target markets benefit from services provided by CDFIs that they could not receive from mainstream financial institutions.

For example, Boston Community Capital, a CDFI headquartered in Massachusetts, has developed a new Stabilizing Urban Neighborhoods Initiative, where the CDFI partners with other organizations to buy foreclosed properties and sell them back to the original owners with a reduced mortgage payment, preventing displacement. As a result, low-income urban neighborhoods in Boston are at less risk of population loss due to unaffordable housing costs.

Another organization, Access to Capital for Entrepreneurs (ACE), which is a certified CDFI as well as an SBA Microloan Intermediary and USDA Intermediary Lender, has done excellent work encouraging the growth of small business ventures in the rural Southeast. For example, an ACE microloan to Melissa Bennett allowed her to expand her cosmetics store to a second retail location in Georgia and to hire more help. The Dazzle Cosmetic Company now has eight employees in a rural area with a high poverty rate.

CDFIs have pioneered new youth financial education initiatives; encouraged the development of green industries and rural manufacturing; invested in transit-oriented development, charter schools, healthcare centers and other community facilities; and have created thousands of jobs through the steady support of small businesses. After both Hurricane Katrina and the gulf coast oil spill, CDFIs were at the forefront of re-building the gulf coast region and providing support for small business owners who saw their livelihoods threatened.

The CDFI Fund supports the growth of a stable community development financial institution industry that will make long-lasting and continual impacts across the Nation.

THE PRESIDENT'S FISCAL YEAR 2012 BUDGET REQUEST

The CDFI Fund's programs offer critically needed funding and resources that result in sustainable growth for the nationwide network of CDFIs. Due to the phenomenal track record of CDFIs leveraging the CDFI Fund's awards with private investment, there is a clear benefit of a large local impact for a small Federal cost. In fact, CDFI Fund awardees leverage their awards with private investment by a factor of 13:1 on average, so it is possible that we may ultimately see more than \$1 billion worth of investment stemming from the \$104.8 million in CDFI program Financial and Technical Assistance awards that were announced in fiscal year 2010. The broad impact that the CDFI Fund's awards make in low-income and distressed communities throughout the country is why the President's 2012 budget request included funding for the CDFI Fund.

The President's 2012 budget request includes funding for Financial Assistance and Technical Assistance grants for the CDFI program. The stability inherent in a CDFI program Financial Assistance award provides the most patient capital available to CDFIs, which is one of the reasons why this program is in such demand. The continued oversubscription of this program guarantees that there will be a high demand for the full amount of funding requested in the President's budget. In a similar vein, the funding proposed for Native Initiatives will support a growing economic development industry in Native communities that consistently request more funding than the CDFI Fund has available.

Included in the CDFI program is grant funding for the Healthy Food Financing Initiative (HFFI). The HFFI is a multi-year, multi-agency effort to increase the availability of affordable, healthy foods in underserved urban and rural communities. Through HFFI, the CDFI Fund will provide competitively awarded grants to CDFIs that are improving access to healthy food in low-income and underserved communities, particularly through the development or equipping of grocery stores, farmers' markets, and other healthy food retailers.

The CDFI Fund also requests administrative funding for fiscal year 2012. These funds will allow staff to meet the resource demands, and to address the significantly increased compliance monitoring requirements. The CDFI Fund anticipates increased information technology and research investment needs in order to continue serving and monitoring CDFIs effectively.

The President's 2012 budget request also supports the Bank on USA Initiative. Designed to address the troubling fact that more than 1 out of every 4 American households is unbanked or under-banked, the Bank on USA Initiative will promote access to affordable and appropriate financial services and basic consumer credit products for households without access to such products and services. Bank on USA will support community-based efforts to identify strategies for serving unbanked and under-banked populations, including the development and delivery of innovative products and services.

The CDFI Fund has seen considerable support from this subcommittee in recent years for program development and appropriations. My deepest thanks go to its members and to Chairman Durbin for your unwavering confidence in the CDFI Fund and our programs. As the economy continues to recover, the CDFI Fund will continue to effectively administer its programs, so that the hardest-hit communities in the country have every opportunity for success and growth.

Thank you and I look forward to continuing to work with you in the future.

Senator DURBIN. Thank you very much.

BUDGETING FOR DISASTERS

Administrator Mills, I visited a major insurance company in New York, and I've certainly visited a lot of them in Illinois. If they write property and casualty insurance, they focus more on weather than almost anything else. They make strategic decisions for their insurance companies as to whether they're going to continue to write insurance in given parts of the country, based on their ideas of weather patterns. A lot of companies moved out of Florida, saying they think there are going to be more hurricanes, that they're going to be increasingly expensive, and that, "We don't want to run the risk."

So, what can we make of what we're going through now, in terms of the Government's role when it comes to disasters? I happen to think we're seeing some changing weather patterns. That turns out to be a pretty hot political debate in Washington. But, insurance companies agree with me, in terms of what they're doing, how they're investing, and where they're protecting homes and businesses. What should we be thinking, at the Federal level, as these changing weather patterns suggest that our vulnerability, our liability as a Government, may increase in the years to come?

Ms. MILLS. Well, we stand, at the SBA, ready to help homeowners and small businesses in every State across the country. And, in fact, we have a state of readiness to go anywhere where we are needed. We have more than 2,000 ready reservists who are not paid—

Senator DURBIN. No, I understand that. What I'm asking you to join me in thinking about is a little bit of long-term thinking, which is hard for us in Government, even in business. But, I'm asking you—okay, look ahead—are you looking ahead? Do you see weather patterns and damage emerging that are just episodic—it's going to come and go—or is this something that we need to be thinking about and planning for the future?

Ms. MILLS. So, we look ahead. And, with National Oceanic and Atmospheric Association, we have briefings on what the assessments are for the coming seasons. I think it's very difficult to say,

you know, for future years. But, certainly for the near-term hurricane seasons, we do take an assessment of how that is.

That said, no—there was no prior indication that we were going to have the worst tornado season. And we have very often, in the past, had other extraordinary events. We've had flooding, we've had terrible hurricanes. And, as I said, we have established, after Hurricane Katrina, a much elevated level of readiness. And one of the things we did is put out this ready reserve so that if there is a pocket of geographic difficulty, as there is right now, we fly in resources to that geography—

Senator DURBIN. I guess—

Ms. MILLS [continuing]. And that allows us to be where others might not be.

Senator DURBIN. I don't question what we do. I'm just questioning about whether or not we have thought about the next year and the year after, and what it means, in terms of our thinking ahead, preparing resources for the eventuality. And maybe that's just very difficult to predict.

Ms. MILLS. Well, that's a good question.

COST OF SMALL BUSINESS LENDING

Senator DURBIN. Well, let me ask you this. When it comes to this 35 percent increase in funds requested for the SBA—I think what you talked about here are actually defaults on loans, and you track that back to real estate values. And I don't question that. I think everyone involved in the credit business in America knows that's a major problem. One of the reasons businesses can't borrow is that they can't pledge the warehouse and the real estate as collateral, because there's a question of the value. Now, that has not, at this point, bottomed out. We've been plumbing for the bottom here, on real estate values, and we're still looking. And sadly, we have many people underwater in their home mortgages, and more foreclosures coming. So, is what we're seeing this year in your budget request likely to be reflected in years to come as real estate values continue to be questionable and lead to more default?

Ms. MILLS. As you mentioned, we've asked for \$250 million in additional subsidy in this budget, which is an increase of \$132 million from the prior year. And the reason for that is that we try to cover our subsidy costs with our fees, but our fees are capped. And we plan to come back, in future years, with a request to allow us the fee flexibility to cover subsidy costs.

Senator DURBIN. Which means raising fees.

Ms. MILLS. Yes, which means raising fees. That said, we are seeing the default rates that are causing the credit subsidy to go up. Those are from the 2005, 2006, and 2007 cohorts. So, those were the times when people borrowed against very inflated real estate costs. That piece is working its way through the system, and we are seeing it being more resolved—on the trend to being resolved rather than on the trend to increasing.

BANK ON USA INITIATIVE

Senator DURBIN. I'm going to save, for the second round, some questions about counseling. But, Ms. Gambrell, I want to go to this Bank on USA Initiative, which means a lot to me. You cannot go

into the poorer sections of my State, in Springfield or Chicago, you name it, without seeing evidence of title loans, pawn shops, currency exchanges, the kind of predatory-lending practices and charges which really take advantage of people in low-income categories. It is almost a shock to know that 1 out of 4 people in America are unbanked; they have no access to banking services. And they really just survive on the street, paying exorbitant fees to cash checks and pay bills and the like.

So, Bank on USA is trying to step in and make a difference. Can you give me any kind of numbers about what we have done, what it has cost, and what the need is?

Ms. GAMBRELL. Thank you for the question, Chairman Durbin. And to your point, certainly we recognize that, when it comes to the unbanked and the underbanked in this country, we're talking about, in many ways, an epidemic. We look at the impact that it's having on low-income communities, minority communities, and others, and you see that—with alternative check-cashers and predatory lenders—that oftentimes these populations are being preyed upon, and there's a devastating impact upon that community, and overall.

The Bank on USA Initiative has multiple components to it. And what we want to do is really go beyond financial education.

Senator DURBIN. What's what I'm looking for is some kind of quantification—what we're spending, what we serve, what the universe of need is.

Ms. GAMBRELL. Okay. Thus far, with the Bank on USA Initiative, that program is not funded for fiscal year 2011. We are requesting funding and the President's budget includes this request for 2012. So, thus far, we have not spent funding on the initiative itself. But, we certainly have worked with other partners, including bank regulatory agencies and others, to get a better handle of the program, to look at the research numbers, as well.

Senator DURBIN. Can you point out any bank, or banks, or credit unions, that you think are making an extra effort to address this problem?

Ms. GAMBRELL. Yes. And actually, I think, when you look at some of the banks in your State, as well as other parts of the country, you have community banks, you also have CDFIs that are not only community banks, but clearly focused on community development—that are focused on financial education programs, but also going beyond that. They're looking for ways in which they can create affordable bank accounts and other types of affordable financial services and products for low-income communities.

Senator DURBIN. I'm going to turn it over to my colleague, but I'd ask you to follow up on that. And if you could give me the names of some of these institutions—

Ms. GAMBRELL. Absolutely.

Senator DURBIN [continuing]. I'd like to be in touch with them. [The information follows:]

ACCION Chicago,
Chicago, Illinois
ACCION Texas, Inc.,
San Antonio, Texas

ACCION USA, Inc.,
New York, New York
African Development Center,
Minneapolis, Minnesota

Alternatives Federal Credit Union,
 Ithaca, New York
 Appalachian Community Enterprises,
 dba Access to Capital for
 Entrepreneurs,
 Cleveland, Georgia
 Aura Mortgage Advisors,
 Boston, Massachusetts
 Bethex Federal Credit Union,
 Bronx, New York
 Broadway Federal Bank,
 Los Angeles, California
 Columbus Housing Initiative,
 Columbus, Georgia
 Communicating Arts Credit Union,
 Detroit, Michigan
 Economic and Community Development
 Institute,
 Columbus, Ohio
 First Nations Oweesta,
 Rapid City, South Dakota
 Frontier Housing, Inc.,
 Morehead, Kentucky
 Grow Iowa Foundation, Inc.,
 Greenfield, Iowa
 Homewise, Inc.,
 Santa Fe, New Mexico
 Hope Enterprise Corporation/Hope
 Federal Credit Union,
 Jackson, Mississippi
 Indianapolis Neighborhood Housing
 Partnership, Inc.,
 Indianapolis, Indiana
 Kalamazoo Neighborhood Housing
 Services, Inc.,
 Kalamazoo, Michigan
 Kentucky Highlands Investment
 Corporation,
 London, Kentucky
 La Fuerza Unida Community
 Development Corporation,
 Glen Cove, New York
 Latino Community Credit Union,
 Durham, North Carolina
 Latino Economic Development
 Corporation,
 Washington, District of Columbia
 Low Income Investment Fund,
 San Francisco, California
 Montana Community Development
 Corporation,
 Missoula, Montana
 Nebraska Enterprise Fund,
 Oakland, Nebraska
 Neighborhood Development Center, Inc.,
 St. Paul, Minnesota
 Neighborhood Housing Services of Waco
 Inc.,
 Waco, Texas
 New Hampshire Community Loan Fund
 Inc.,
 Concord, New Hampshire
 New Mexico Community Development
 Loan Fund,
 Albuquerque, New Mexico
 Northeast Entrepreneur Fund, Inc.,
 Virginia, Minnesota
 North Side Community Federal Credit
 Union,
 Chicago, Illinois
 Northwest Ohio Development Agency,
 Toledo, Ohio
 Northeast South Dakota Economic
 Corporation,
 Sisseton, South Dakota
 Opportunity Fund,
 San Jose, California
 Oregon Microenterprise Network,
 Portland, Oregon
 Pacific Community Ventures, Inc.,
 San Francisco, California
 Premier Bancorp Inc.,
 Wilmette, Illinois
 Rural Community Assistance
 Corporation,
 West Sacramento, California
 ROC USA Capital,
 Concord, New Hampshire
 Seedco Financial Services,
 New York, New York
 Self-Help Federal Credit Union,
 Durham, North Carolina
 St. Louis Community Credit Union,
 St. Louis, Missouri
 The Housing Assistance Council,
 Washington, District of Columbia
 The Housing Fund, Inc.,
 Nashville, Tennessee
 TMC Development Working Solutions,
 San Francisco, California
 Valley Economic Development Center,
 Van Nuys, California
 Vermont Community Loan Fund, Inc.,
 Montpelier, Vermont
 Western Massachusetts Enterprise Fund
 Inc.,
 Holyoke, Massachusetts
 Wisconsin Women's Business Initiative
 Corporation,
 Milwaukee, Wisconsin
 Wyoming Women's Business Center,
 Laramie, Wyoming

For more information please visit <http://www.cdfifund.gov/docs/Financial%20Education%20and%20CDFIs%20062911.pdf>

Senator DURBIN. Senator Moran.
 Senator MORAN. Chairman, thank you.

CDFIS IN RURAL AMERICA

Ms. Gambrell, I want to bring the rural aspect to your attention—of what you do. My home State of Kansas has received only 17 awards in the last 14 years, totaling \$4.7 million. I think this comes from information that you provided.

Ms. GAMBRELL. Correct.

Senator MORAN. And, at this time, there's only two certified CDFIs in Kansas, one in Topeka and one in Wichita. And my question is, What are you doing—what's the agency doing to make certain that rural aspects of your mission are cared for, are provided for?

Ms. GAMBRELL. Thank you, Senator Moran. The CDFI Fund is focused on both urban and rural populations in rural communities. And, in fact, when you look at the number of CDFIs that are serving rural markets, you'll see that it's somewhere close to 24 percent. In your State of Kansas, you're right, about \$4 million have been made through awards to organizations in Kansas.

But, I would call your attention, as well, to the investments that happen in your State from those CDFIs that are not located in Kansas. And it's close to about \$10 million, I believe, where regional or other national organizations have looked at projects and initiatives within the State and said, "We'd like to make investments there."

Now, I'm not satisfied that there are such a low number of CDFIs in the State of Kansas. I'd like to remedy that. I think we can do better. And one of the things that we continue to do as an organization is to work with Members of Congress, but also look at ways in which we can address some of those gaps where there are not CDFIs in certain communities, and really look for ways in which we can build upon that.

Senator MORAN. Is—are the—is the circumstance in Kansas—is it representative of rural America?

Ms. GAMBRELL. No, not—

Senator MORAN. Or are we unique in what at least appears to me to be a low number of participants?

Ms. GAMBRELL. You're—you—Kansas may be a little unique. We certainly are seeing, in other rural communities, where there is a larger number of CDFIs. We're also seeing where there are larger amounts of investment. Now, that's not to say that in rural communities there are not challenges, as there are, I think, in all parts of the country. But, clearly, what we want to do is to build the capacity of those organizations and help reach out to the residents in those rural communities to identify, in a very targeted fashion, those initiatives and those projects that are actually going to help transform communities.

Senator MORAN. I look forward to—assuming that you're willing—to follow up with you and see if we can't help in that regard.

Ms. GAMBRELL. I look forward to that, Senator. Thank you.

Senator MORAN. Thank you very much.

BANKING REGULATIONS AND SMALL BUSINESS LENDING

Ms. Mills, a couple of questions. First of all, do you see a connection between what I believe, and what I hear from my bankers, is

an—my commercial bankers—is an increasing regulatory environment—the uncertainty of what’s next, kind of, in the financial regulatory world, that I think has a consequence upon ability to make loans? As a—if that’s true—if you agree with that, that there is an increasing regulatory environment upon financial institutions, is there a greater demand, then, for the SBA guarantee and loan programs to assist those banks to make those loans more likely? Is there an increasing demand, based upon the regulatory environment that financial institutions are facing?

Ms. MILLS. Well, certainly—Senator, it certainly was the case in October 2008 when the credit markets froze, many, many banks faced increased scrutiny from their regulators, and that came down in a number of ways. As a result of that, many banks pulled back, and they were afraid to take risk. And they had to also put up greater capital reserves, and that, once again, did not allow them the latitude to back all the small businesses in their community.

We saw—when we put out the ARRA grants and we increased our guarantees to 90 percent, we saw an enormous jump in our loan volumes. And, in fact, our loan volumes are back at 2008 levels. So, we have filled the gap that was created by many banks pulling back out of the market.

We are seeing that ease, because we have pushed very hard on the regulators to be clear in their communications. And what bankers and small businesses don’t like is conflicting responses. So, we have made sure that the guidance that is given around small business lending has more and more clarity and that it opens up the opportunity for these banks, particularly community banks, to come back in the lending game, in addition to the way they’ve come back to the SBA.

We’ve added 1,200 new community banks, who had not made an SBA loan since 2007, in ARRA and in the Small Business Jobs Act.

Senator MORAN. Do you see that number flattening, continuing, or decreasing the number of those loans or the number of banks making those loans?

Ms. MILLS. We see the number of banks—we have about 5,000 of the 8,000 banks that are out there that now have some kind of SBA activity on their books. So, we have very strong penetration. What we are concerned about is that the recovery has gaps in it, and some of the gaps are in small loan sizes and in underserved markets. So, we have accelerated our efforts in those two areas with programs called “Small Loan Advantage” and “Community Advantage”, which actually works, with CDFIs and other financial institutions, to reach places where we don’t have enough points of access now.

SBA DISASTER LOANS

Senator MORAN. Tell me about the relationship between the SBA and the Federal Emergency Management Agency (FEMA). And do the requirements for SBA assistance following a disaster—do they mirror FEMA’s designation of a disaster area?

Ms. MILLS. We work extremely closely with FEMA. And I have been traveling with Secretary Janet Napolitano and with the FEMA administrator, who has been just terrific. And we colocate, in almost every location, with FEMA, when we are jointly at disas-

ters. There are occasions where it is not a Presidentially declared disaster, it is a State disaster, and the Governor—will be a smaller disaster—the Governor would ask me, at the SBA, to declare that disaster. And we would go in independently. And in that case, we would carry the burden of, you know, helping those homeowners and small businesses. But, in all of the ones you're seeing right now, we are jointly active with FEMA.

Senator MORAN. In the absence of a Presidential declaration, a Governor's declaration of a disaster is sufficient for you to provide loan services to those affected by that disaster?

Ms. MILLS. Correct. A certain number of houses and a certain number of businesses are damaged. The Governor will ask me to declare that area. And we also do the surrounding areas, because a business in one area might draw its business from surrounding counties. So, we include those, and then they become eligible for SBA, and we drop people into the location.

Senator MORAN. You mentioned housing, and yet the word "businesses"—it's the SBA. What role do you play in assistance for housing following a disaster?

Ms. MILLS. Because we are on the ground, and in order to avoid duplication of folks there, we also take on the responsibility for making home loans to people whose homes have been affected by the disaster. So, we make three kinds of loans: injury to homes, injury to businesses, and economic injury to businesses, where your roof is still fine, but your business is affected. And this was very true in the gulf area. So, we do all three.

Senator MORAN. And the advantage to the person who suffers the disaster is the certainty of the availability of credit and a lower interest rate than would presumably be available elsewhere?

Ms. MILLS. Correct. These are long-term, low-interest loans. And we tend to provide a broader set of insurance—broader set of financing than insurance will provide. So, insurance, when they get their insurance receipts, they repay the piece of the loan, but we will generally cover more.

Senator MORAN. The recent Government Accountability Office report indicates that there is perhaps duplication between FEMA and SBA in programs. I assume that you've seen the report, read the report. Do you agree? Are there things that—are—that are duplicative in regard to your two agencies?

Ms. MILLS. I have not actually seen that piece, but we will look into it. But, I do not believe—and I have been out in the field now—I've been to the flooding in Nashville; I've been to the tornados in Mississippi; I've been to the tornados in Alabama and to see, also, hurricane damage. And we operate side by side with FEMA. If someone does not qualify for an SBA loan, we refer them to FEMA, and they may qualify for FEMA grants. So, we actually are very highly aligned and not duplicative.

LOAN SERVICING

Senator MORAN. My final question, Mr. Chairman, is I have heard, from Kansas bankers, some frustration with the level of services provided by the SBA. They attribute that to a consolidation of processing in—apparently, in a facility in Virginia. Is that

a complaint that you're aware of? And is there something that's being done? And are my bankers telling me the truth?

Ms. MILLS. Senator Moran, I am aware of your Kansas bankers and their concerns. In—several years ago, we consolidated all of our loan approvals in centers around the country to ensure oversight and nonduplication. Before that, every single office had its own loan approval authority. And frankly, in order to save money and eliminate duplication and increase the quality of the credit decisions and the uniformity of the credit decisions, we centralized those functions some years ago.

Many bankers and offices miss that ability to make a local decision. That said, we track very carefully the turnaround times. They are in days. And we are very, very good now at aiding customers and processing these loans across the country. And we are happy to talk further to your bankers to make sure they're getting the service they need.

Senator MORAN. I'll do the same. I guess, my question is—I wanted to make certain that there is not an unnecessary delay in this consolidation. And I'll be glad to have that conversation with you and my bankers, perhaps at the same time.

Mr. Chairman, thank you very much.

Senator DURBIN. Thanks a lot, Senator Moran.

Senator Kirk.

Senator KIRK. No questions. I'm waiting for the second panel.

Senator DURBIN. Okay. If I can ask a follow-up question or two.

SBA MICROLOANS

Administrator Mills, let's talk about microloans for a second. The average microloan to small businesses is about \$13,000. And I'm concerned, here, that your request for next year's budget dramatically cuts, by 55 percent, the amount of money available to counsel microloan borrowers. Those would seem to be the small businesses most in need of counseling. They are looking for small loans. I would guess that many are startup businesses. And we know the failure rate of businesses in the early days. So, how can we justify cutting back on counseling when it comes to this level of lending?

Ms. MILLS. The first thing I want to say is how much we appreciate your support of the Microloan Program. And, in fact, for next year, I want to emphasize that the actual amount of money going into the microloans is remaining at the current levels. We think this is a critical program. Our volumes are up, and we track it very carefully. And we have very, very good results from this program.

We looked across this issue of duplication of counseling benefits, and one of the things that we found is that we think that counseling in the microloan arena is better done by our partners, and that our contribution really should be to create more loan product, more lending dollars, and make sure that the counseling, which we think is absolutely critical, is done by our lending partners who are on the ground.

So, what we have done, in Community Advantage, is try to make a shift to doing what we do best and what we do the most efficiently, which is provide the dollars, and to work with them to make sure they take advantage, if not of the counseling and those

operations, the counseling in nearby women's centers and small business development centers.

Senator DURBIN. I was going to ask you, when you say "partners", to whom are you referring to?

Ms. MILLS. Well, we have a set of counseling partners all across the country. And that involves 900 small business development centers, 110 women's centers, and 12,000 Service Corps of Retired Executives (SCORE) members and 350 chapters. We want to focus on those, making sure that those programs are functioning, they're cost effective, and that they're not duplicative, and focus our attention, in the microloan arena, in the area where I think we really give a much better bang for the buck, which is providing loan capital.

Senator DURBIN. So, let me ask you about that aspect. The Microloan program can accommodate up to 300 lenders. There are only 177 SBA-approved microloan lenders. In fact, in Illinois, there's just one: ACCION Chicago. Many small businesses in the rest of Illinois don't have easy access to SBA microloans. It appears to me, we need to increase the number of microlending partners, which mean that more small businesses will have access. What are we doing about that?

Ms. MILLS. We actually have a program that was funded in the Jobs act. The request for additional lenders just went out for intermediaries. And we are looking to add to that. In addition, we implemented "Community Advantage," where we take CDFIs and we allow them access to our 7(a) program. This is really powerful. And the community has been asking for this for many years, because the 7(a) program is a broad and powerful program with much stability. And we now allow CDFIs—many of whom are our microlending intermediaries, to come into that program. It gives them enormous capacity.

CDFI HEALTHY FOODS

Senator DURBIN. Director Gambrell, one last question. And I thought Senator Moran was going to ask this. I'll ask it instead. And it's about the Healthy Foods program. In my hometown of East St. Louis, Illinois, it was literally a food desert for the 25,000 or 30,000 people living there. There was just no place to shop. And, as a consequence, they were stuck with high prices, limited variety, and certainly not the healthiest alternatives, when it came to shopping. Then, along came Schnucks, a major grocery chain in St. Louis, opening up a store at 25th and State Street, my old neighborhood. And it transformed the town. They had a place to go. Everybody went shopping.

Same thing happened in Chicago, on Roosevelt Road. There was a day when there were just no grocery stores in that area. And now there are a lot of them, which reflects a changing population and a commitment by these grocery chains.

So, the First Lady and the President are pushing these healthy food alternatives, particularly for low-income families. And I know that they have an initiative that they've started. Can you tell me a little bit about what has been achieved to date and what you anticipate achieving in that regard?

Ms. GAMBRELL. Thank you, Senator. So, the Healthy Foods Financing Initiative is one that the Treasury Department is proud to be a partner with the Department of Health and Human Services, as well as the Department of Agriculture—three agencies that have committed to looking at ways in which to address issues in food deserts.

For the Treasury's part, the CDFI Fund is, again, a major partner. Thus far, we have sent out a healthy food supplemental questionnaire, as part of our competitive award round, under our Financial Assistance Awards, and we'll be getting that back from those applicants that have said, "Yes, we want to be a part of this initiative, and this is how we can be"——

Senator DURBIN. Who received the questionnaire?

Ms. GAMBRELL. These are from the applicants that actually have already applied for Financial Assistance Awards and indicated that they had an interest in applying for a healthy food——

Senator DURBIN. Can you generally describe them? Are they farmers' markets? Are they grocery chains?

Ms. GAMBRELL. It really runs the gamut. And that, I think, is what we have certainly seen within the CDFI Fund industry, that we are looking for those CDFIs that are interested in bringing retail outlets, grocery stores, to those low-income communities. But, they are also involved in co-op markets, farm markets, distribution channels that actually transport food from local farmers into those food outlets, as well. So, it really does run the gamut.

Senator DURBIN. Great. Thank you. Any other questions?

Senator MORAN. Mr. Chairman, I apologize for not living up to your expectations. The food deserts are an important aspect—and again, I would—of something we're trying to make certain it doesn't continue. And there—I would just want to point out, once again, and—often thought of a food desert as an urban area. And we have those circumstances in Kansas. But, it's also—very much a rural issue, as well.

And I'd again just highlight my earlier emphasis on making certain that our programs are designed to reach all areas of the country. And nutrition—in my view, one of the best things we can do for improving the healthcare of Americans, and thereby saving healthcare costs, is related—are nutrition, diet, exercise, and just this general wellness.

And so, these are important issues. And I didn't want Chairman Durbin to be disappointed in my failure to express my views. But, more importantly, I want to make sure that we follow up and work together to figure out how we address this issue that's apparently particularly Kansas oriented.

And you maybe have been telling me that there are CDFIs in Kansas City, Missouri, who are providing services in Kansas, as I thought about your answer about other States. And that makes some sense to me—our significant urban area along the Missouri border. So, look forward to having that dialogue.

Thank you.

Ms. GAMBRELL. As do I, Senator. Thank you.

Senator DURBIN. Senator Moran, thank you very much.

And as Senator Kirk and I can tell you, there are parts of Illinois, downstate, that look an awful lot like Kansas. So, we have communal interest in a lot of these issues.

Thanks, to this panel. We appreciate your testimony. And we'll be back in touch with some other follow-up questions as we prepare the budget for the next year.

I'm going to welcome our second panel to the table and introduce them as they come up. Our first witness is Warner Cruz. He secured a loan, under an SBA program, to expand his business during the worst part of the recession. Mr. Cruz is a graduate of Augustana College, in Rock Island—which Senator Kirk just visited—and has a degree in international business administration and finance, minoring in Japanese. He worked for 3 years in Japan. And even while working in Japan, he stayed integrated in the company that his father had started. He's now the president of J.C. Restoration, a small business that restores commercial and residential properties that suffered loss from fire, water, or storm damage.

Next, we welcome Calvin Holmes, president of the Chicago Community Loan Fund, a Chicago CDFI. Mr. Holmes' community development career spans 25 years—he looks too young for that, but that's what it says—including work as a budget planner for rapid transit projects and property manager of a 200-unit assisted-living housing portfolio. Under his leadership, CCLFs lending has averaged nearly \$1 billion in additional public and private sector capital in more than 55 lower wealth Chicagoland communities. He holds a master's degree in urban regional planning from Cornell and a BA in African-American urban studies from Northwestern.

Finally, we welcome Ray Moncrief. He's the Executive Vice President and COO of the Kentucky Highlands Investment Corporation. He manages investing activities, including analyzing new investments. Mr. Moncrief has traveled nationally and internationally, speaking about the use of equity instruments as an economic development strategy. He sits on the board of several financial institutions and on the advisory boards for government agencies, to support community and small business development and venture capital. He's a graduate of Louisiana Tech.

We're going to start with Mr. Cruz for an opening statement, allow that to the other two witnesses, and ask a few questions.

Please be my guest.

STATEMENT OF WARNER CRUZ, ILLINOIS SMALL BUSINESS PERSON OF THE YEAR, 2010, PRESIDENT, J.C. RESTORATION, ROLLING MEADOWS, ILLINOIS

Mr. CRUZ. Good morning, Senator Durbin, Senator Moran, Senator Kirk, ladies and gentlemen. My name is Warner Cruz, and I am 38 years old. I am a husband, a father, and a proud owner of a successful family business that is overwhelmed with blessings.

I'm here before this panel to testify about the tremendous impact the SBA's 504 loan program had on my firm. In fact, I am confident that if it were not for the 504 blessing, I would not be here today.

The name of my business is J.C. Restoration (JCR), located in the suburbs of Chicago. The "J.C." stands for Jose Cruz, my father, who immigrated here from Guatemala in the early 1970s. With no

money, formal education, or the ability to speak English, he eventually incorporated the business in 1982. Today, JCR is an industry leader in the disaster restoration field. Our core business is to restore commercial and residential properties that have suffered loss from fire, water, or storm damage across the United States.

In 2002, I purchased the business from Mom and Dad and became 100 percent owner. After 7 solid years of 25 to 35 percent average growth, I felt it was time for JCR to really expand. Thanks to the SBA 504, I was able to obtain a loan and more out—move our business from a 13,000 square foot warehouse to our current 102,000 square foot, state-of-the-art facility. We invested more than \$3 million on seven acres in transforming this once abandoned eyesore that sat dormant on seven—beautiful acres of land off of a major expressway. Our new building gleamed with a completely new energy efficient roof, light fixtures, and mechanicals, all designed with green in mind. Life was good.

But, I haven't told you about the blessing yet. By the end of the third quarter in 2009, JCR sales plummeted 9 months in a row, due to the economic recession. The shock of moving into our new facility with great hopes of being able to handle the overabundance of work from the previous years was quite unnerving. Our sales decreased 29.4 percent, and we had to go into our own disaster response mode. The hardest thing I had to do was lay off 19 of our employees.

The true blessing was this: if it weren't for the SBA 504 that stabilized my \$2 million loan at a fixed rate of 4.4 percent over 20 years, I don't know what I would have done. The program preserved my working capital to where it was needed the most. I had great ease of mind knowing a conventional banker wasn't going to call me to raise their rates or devalue my property. The SBA 504 worked beautifully in the way the program was designed to protect me from inflationary pressures that I had never anticipated would happen.

My testimony today is out of gratitude to the SBA. Not only did my business survive, today JCR is on pace to exceed sales of \$20 million, after having our best year, last year, at \$13.8 million. We currently employ more than 150 full-time and part-time jobs. The SBA 504 loan program helped save my business.

But, more powerful is, in 2010, JCR kept 67 businesses in business, including two hospitals and a major manufacturing plant that employs more than 300 workers, after they suffered a major disaster. The SBA should be proud in knowing they indirectly assisted in this creation and retention of hundreds of American jobs by blessing JCR with the 504 loan program.

Thank you.

Senator DURBIN. What a great story. I was just telling Senator Moran, we knew a little bit about your background, and it's just wonderful that you can come and tell us that story.

Calvin Holmes, your turn.

**STATEMENT OF CALVIN HOLMES, PRESIDENT, CHICAGO COMMUNITY
LOAN FUND, CHICAGO, ILLINOIS**

Mr. HOLMES. Okay. Thank you, Sir. Good morning Chairman Durbin, Ranking Member Moran, and Senator Kirk. And thank

you, Chairman Durbin, for showcasing two of our recent investments in low-income communities in Chicago.

It's an honor to speak with you today about the critical and effective role that CDFIs play in promoting economic growth. Thank you for the opportunity and for your long-term support of the CDFI Fund, which is the critical permanent capital financier to CDFIs.

I know that you've already heard from Director Gambrell, but I also want to thank her, because, in my humble opinion, she is the venture capitalist to the poor.

I run the Chicago Community Loan Fund (CCLF), a private, non-profit financial institution certified by the CDFI Fund and a member of the Opportunity Finance Network. Since 1991, CCLF has been investing in nonprofit and for profit community developers, providing flexible financing and—for economic initiatives, and filling gaps in the marketplace as they arise.

At \$28 million in capital, we are clearly dwarfed by regulated financial institutions. However, we have lent our dollars over and over again to help our borrowers attract more than \$900 million in additional capital for their projects to make 222 loans, supporting 6,400 units of housing, 1,300 jobs, and 2.1 million square feet of commercial and facility space. Historically, we have leveraged \$20 for every \$1 we invest. Our cumulative charge-off rate, over all this time, remains below 1 percent. Without the CDFI Fund program investments, little of this would be possible.

Given high unemployment rates in underserved communities, we are especially proud of two recent projects. One of them is on the board. Last July, one of our borrowers opened a \$150 million Wilson Yard project that included 178 units of affordable housing, a Healthy Foods, new Target and Aldi stores, and additional retail space for more goods and services. Target hired 300 workers, 80 percent of whom live within a 2-mile radius of the store. The CCLF's \$1 million predevelopment loan helped the project move forward.

The CCLF is very involved in helping stabilize communities devastated by foreclosures, providing loans to small developers to rehab abandoned homes through the city of Chicago's Neighborhood Stabilization Program (NSP). Our loans are not only stabilizing housing, but keeping small firms afloat during the housing market downturn. We estimate that more than 50 percent of the 23 developers participating in the NSP might be out of business without the program, and 458 tradesmen and women have been kept employed.

Simply, a lender like us that makes a loan before all the takeout financing is in place, and to smaller organizations, must have high capital ratios. Without question, the CDFI Funds awards are the most important way we do so. Every \$1 we have received from the CDFI Fund at a critical juncture has allowed us to recruit at least \$3 more in private capital. For these reasons, it is vitally important that the \$227 million in the President's fiscal 2012 budget requested for the CDFI Fund is appropriated. We know that there are many tough decisions to make, but supporting distressed communities in this way is critical.

I look forward to continuing to work with you, and thank you again for your support.

Senator DURBIN. Thanks, Mr. Holmes.

Mr. Moncrief, it's good to have you here. Your perspective from Kentucky is a little different than the big city perspective, so we're anxious to hear your testimony.

STATEMENT OF RAY MONCRIEF, EXECUTIVE VICE PRESIDENT AND CHIEF OPERATING OFFICER, KENTUCKY HIGHLANDS INVESTMENT CORPORATION, LONDON, KENTUCKY

Mr. MONCRIEF. Thank you, Chairman Durbin, Ranking Member Moran, Senator Kirk. It's a pleasure being here.

It's an honor to sit before you today to tell you about what we do, connecting the SBA and the CDFI Fund. I hope that, when I leave today, that my testimony shows that they don't compete, but they complement one another. And they're very vital, specifically in the area that I work, Senator Moran. I live in rural eastern Kentucky. Your comments on the radio the other day resonated with me where I live.

I work for an organization that was just 43 years old who stimulates the local economy through the creation of businesses that hire people through employment. They accomplish this through financings in equity capitals, through subordinated debt, difficult financings to do. We do this with small businesses. And by "small businesses," let me explain. The SBA defines a "small business" as any business, 500 or fewer. The average size of a small business that I deal with are 14 employees, excluding government employees, schools, et cetera. So, I deal with very small businesses that require significant counseling.

In addition to that, the banking crisis has been dramatic in our area. One example that I'd like to leave with you is that we have a manufacturer that hires 200 people whose bank was acquired by a larger regional. They were on the edge. They had not been profitable for 2 years. And they were told to seek their financing elsewhere. Because of where we are, we were able to put a financing together with another local community bank and provide a \$1.5 million working capital line of credit for that facility to maintain those 200 jobs.

The Microloan program is very important to us. We've—we have borrowed more than \$3.8 million since its inception in 1992. We've invested in more than 300 businesses. Last year alone, we did 36 financings for \$850,000.

Administrator Mills spoke about the Community Advantage Program. We are one—we were the very first Community Advantage lender in the United States, connecting the dots between the CDFI Fund and the SBA.

The product called the SBA loan—Administrator Mills said that many of the banks in our area don't use that program. They don't, because of the rural nature, the hard-to-get-to, the size of the community banks, et cetera. So, we, as a CDFI Fund that's using the Community Advantage Program—it's vital for us to be able to offer the guaranteed loans that we do. The CDFI Fund is absolutely paramount, because we have to have the money to make the guaranteed loans. And the CDFI Fund and its FA awards allow us to capitalize our balance sheet and use those funds to indeed make those guaranteed loans under the 7(a) program.

So, it is with that I'd urge this subcommittee to keep the SBA Microloan Program alive, thriving, as well as the CDFI Fund, at its current level of funding. Both are extraordinarily important to what we do, where we do it.

Thank you.

Senator DURBIN. Thanks, Mr. Moncrief.

FORCLOSURE CRISIS AND DEVELOPMENT OPPORTUNITIES

I'm going to, in the second round, address the other two witnesses. But, I'm just going to ask Mr. Holmes a question now so the other Senators have their chance.

I've seen this movie before. I grew up in East St. Louis, Illinois. It was a town of 80,000 people, now in the range of 25,000. In the early 1960s, white flight meant that people just left their homes behind. And as they did, the homes were abandoned, burned out, gutted, eventually bulldozed, and now it looks like a victim of some aerial bomb attack; the city just has so many vacant lots. Same thing is going on in Detroit. It's going on in a lot of places. I fear what's going to happen in the Chicagoland area, because I can see the same story playing out in areas like Marquette Park, where there are high foreclosure rates in otherwise long-time stable neighborhoods with great home stock—you know, these brick homes that we valued in Chicago became the trend after the Chicago fire.

But, I'm asking you—because you talked about something that really catches my attention, of trying to help people finance the reconstruction or reoccupation of these homes. One of the obstacles I've seen in this is trying to find a bank that will cooperate. It seems that many banks are hell bent for foreclosure. And I don't understand why, because their asset is going to disintegrate to zero value if they go through foreclosure and don't have quick sale or reoccupation of the property. So, tell me—put this in perspective—tell me how it works, where you've been able to make it work to go into these foreclosure scenes, and what we might do to make sure that there's a better opportunity for that.

Mr. HOLMES. Got to remember to turn the talk button on.

Senator Durbin, let me first say, it's really heartwarming to me to hear you talk about my hometown, as well. You may recall that I'm also a native of East St. Louis and my mother still lives there, at 88th and State Street. And, as you talked about the Schnook store that came online at 25th and State, I, too, celebrated not having the entire town be a food desert. So, it's always good to see, as they say in our neighborhood, a "homeboy".

So, the foreclosure crisis, it is a pretty daunting experience, right? We are working with one- and two-person general contracting shops, many of them who would have been out of business today if they were not getting construction bridge loans for us in order to rehab these homes and to keep their crews alive. That's one of the things I very much wanted to do.

One of the reasons that we are able to operate in this environment—and you so astutely noted, earlier, that the real estate values are continuing to decline in a number of these neighborhoods. So, when we look at loan-to-value, it's hard to get your comfort there. What we have, through the NSP, is a guarantee from the

city of Chicago, is that they will work with us to make sure that, one way or the other, we will get to the finish line, so that, as a lender, if—we can make sure that the construction process is handled well and goes to plan, and get that building rehabilitated. If for some reason the absorption is not there, there isn't a home buyer on the other end immediately, the city assures us that they will work with us to make sure that we don't lose our shirts. So, that's one of the ways in which we work.

Increasingly, however, in partnership with the city of Chicago and its administrator, through the MSP program, Mercy Portfolio Services, we are having a series of conversations with local banks, both regional and national, to bring them to the table so that they can provide end mortgages so that, at the end of our construction loan, there is a home buyer. And we're also working with them on other commercial mortgage products so that they can help us accelerate the rate at which we rehabilitate these homes in our devastated communities.

Senator DURBIN. My last question goes right to that point. The problem I've run into in the foreclosure situation is figuring out who makes the decision. You have a servicing bank, you have many lenders, you have all kinds of loan instruments and derivatives. It's hard to get anyone who can say yes or no. How do you break through all that to finally find someone who can make a critical decision about the future of that property—to get the bank to answer the phone and cooperate?

Mr. HOLMES. Well, Senator Durbin, it's a complicated process, as you well know. So, one of the initiatives that we're involved in, in Chicago, to be able to help the banks understand that it's in their best interest to participate with the community, is something called the Regional Home Ownership Preservation initiative, where we have a number of stakeholders, both at the public sector level, the private sector level, and the community organizations, who, through this collaboration, can get the attention of the decision-makers and get them to make decisions. And there are some successes, where we have a number of banks who are offering up portions of their real-estate-owned portfolio, so that the community can take possession, or a nonprofit, or a joint venture between a for-profit and nonprofit, and rehabilitate those homes. So, through this collaborative nature, with the public sector at the table as a convener, we're starting to make some headway.

Senator DURBIN. Thanks.

Senator Moran.

Senator MORAN. Chairman, thank you.

PUBLIC-PRIVATE PARTNERSHIPS IN CDFI PROJECTS

Mr. Holmes, the Target photograph and the story that you told, I assume that Target, or any other company, would not have made that decision without some support. And I just want you to describe for me what it was that was—you were able to do that induced Target to believe this is a profitable location.

Mr. HOLMES. Well, the simplest way to think about our role in a \$150 million transaction is, we help our borrower, who's the real estate developer, acquire all of the property, take care of all the encumbrances that make it really messy for a large retailer to even

think about a site like that. So, by putting \$1 million on the table earlier on in the deal—and there were other CDFIs, thankfully, that were involved in the process, as well; this is a really big project, so there were some other layers of even predevelopment financing—but, we all worked together to take care of that site, so that Target knows their developer—

Senator MORAN. You created the—excuse me for interrupting, but you created the environment by which Target now believes it can succeed, as compared to providing any kind of direct benefit to Target.

Mr. HOLMES. Exactly. But, a real easy way to think about it is that Target is not going to spend its R&D time, its staff focus time, its marketing time, its business planning time if the developer that is trying to recruit Target does not have site control. If Target doesn't believe that a developer can pull off the project, then they're not going to plan to open a store there. So, our money helps the developer go to Target and say, "Don't worry about this. The city's behind us. We've got our financing lined up. We've got site control. We've taken care of all the encumbrances. We've still got other layers of financing to put in place, but you can rest assured that this project will move forward."

GROCERY STORES AND COMMUNITY DEVELOPMENT

Senator MORAN. Mr. Moncrief, you also mentioned grocery stores. For much of the time I've been in the Congress, in the House, I have told my colleagues that—it goes back to the food desert conversation we had earlier—that, particularly where I came from as a Member of the House of Representatives, economic development can be whether or not there's a grocery store in town. It's what many people would consider very much the basics.

I recall, after the tornado, in Greensburg, of now about 5 years ago. Greensburg was the town hit by the F5 tornado—destroyed the entire town. One of the first conversations that people had with me and others—community leaders—was, Is Dillon's going to rebuild the grocery store? It was a determining factor as to whether anybody was going to live there. And I wonder if you have the experiences that would help keep Kansans and others figure out how we have those basic services in communities. How do we make sure the grocery store is there?

Mr. MONCRIEF. Thank you, Senator Moran. Indeed, we have invested in grocery stores in those food deserts, where people don't have access to healthy foods.

First of all, grocery—the grocery business, if it's nonchain, is very entrepreneurial. It requires all the products that we're talking about, things like SBA microloans, things like some of the money that we use from the CDFI Fund, and others, including venture capital.

We recently did a grocery store in a rural part of Congressman Roger's district, where people had to drive 25 miles to buy any type of grocery. We worked with that business to help it grow. And ultimately, it grew to such a size that it was actually sold out to a larger chain, which really had an impetus in that particular area, so that they brought all of the multiline food products to that particular area.

The problem that we faced in the interior of Appalachia truly is one of healthy foods. There are people that don't have access to the basic amenities in the mountains of Appalachia, much less groceries. They have to drive miles and miles and miles. And according to the Appalachian Region Commission, many times Sunday lunch is a bag of Frito Lay potato chips. So, it is a problem that we're facing constantly, working with entrepreneurs to help them organize and create grocery products in those food deserts.

IMPACT OF REGULATIONS ON COMMUNITY BANKS

Senator MORAN. Mr. Moncrief, one of the other things that you mentioned that particularly caught my attention was about the ability for a local bank to provide lending to a near-failing company, I guess, or a company that was struggling. And it's one of the concerns I have that I've tried to highlight, both here in this subcommittee, but as a member of the Senate Banking Committee. In my view, the regulatory burden that community banks are facing, increasing the cost of being in business, which generally means that either a marginal bank no longer continues to exist in a community or it becomes a branch of some larger banking organization. And I was hoping that you—you don't have to confirm my belief that the regulatory environment is the cause of this, but I would love to have you confirm that there are dramatic consequences to the ability of our communities to survive, to prosper, to grow in the absence of that hometown financial institution. And if we can alleviate that trend, or reduce the likelihood—I suppose I'm willing to see small banks, small financial institutions go out of business if that's the nature of the market forces, there's no option, but for them to go out of business because Government is putting such a regulatory burden upon them that the cost of being in business is so high that they have no choice but to spread those costs among a much larger financial institution—my question to you is, Can you give me the evidence, can you support my premise, that there is a bad consequence that occurs in the absence of hometown financial institutions?

Mr. MONCRIEF. Senator Moran, I would have traveled to Washington, DC, just to answer this very question. It's a very important question. Bank consolidation is the worst threat to rural economic development that exists, so much so that we find banks that we've worked with, in the years that I've been doing this, that we no longer work with, because they've been acquired by a larger regional that's been consolidated, and the corporate headquarters are in a distant city, which means that those banks that aren't bankable, under—according to credit scoring sorts of things, don't receive the financing that they need.

There literally are trillions of dollars pent up in the banking institutions today that cannot be lent because of the regulatory environment that we in, at present. There are banks that I go to every day—a typical example is, today, I was sharing that I am in a problem with a small business, that's paying \$5,000 a month for one of its loans, that breached a covenant and is in foreclosure procedures today. It will put about 35 people on the street if we don't avert that, working in the special assets section of this bank, because of regulations that says that this bank had a—or, this com-

pany had a loss, it doesn't have quite the cash liquidity, although it is servicing its debt, that bank—that company likely will be sold, likely would go out of business, if we don't avert the foreclosure procedure by that bank.

Regulation is gruesome, is brutal and burdensome, and it is the regulators that decide who to preserve on the balance sheet and take income for those loans.

Senator MORAN. I'm glad you made the trip to Washington, DC. And thank you for confirming both aspects—

Mr. MONCRIEF. Absolutely.

Senator MORAN [continuing]. Of my premise.

Mr. Cruz, thank you for your testimony. The key to our country's future of success is the ability of entrepreneurs and small businessmen and women to succeed. In the process of pursuing a profit or pursuing the creation of wealth, you put people to work. And anytime we can tell the story and see the role model, the success that you provide today, it's a great story for America. And it ought to be goal—and I'm certain that it is—the goal of every Member of the Senate to see that the American Dream can be fulfilled, as you and your family are doing so. Thank you for the inspiration.

Thank you, Mr. Chairman.

Senator DURBIN. Senator Kirk.

Senator KIRK. Well, Mr. Cruz, I also want to congratulate you as an "Augie". I just got back from Augustine, and I'm—yesterday—and President Bahls would be pretty proud of you and what you did. I just moved into, I think, a 600 square foot apartment. So, to think about a 100,000 square foot facility, that is more space than I can possibly imagine, given what I just did.

And, Calvin, you're a fellow Cornellian, and I'm very proud of you, as well, and what you've been able to do here. I don't know if you ever worked with Karen Muchin, very much in the CDFI Fund world—I've known her for 25 years, and very impressed with this—what you've been able to—done.

SBA LOAN PROCESSING

To Mr. Cruz, I should say, gracias, or more—the language you're probably more familiar with, arigato, in Japanese. Let me just ask you about what else we could do for you. One of the big reasons why I ran for the Senate was to enact the Small Business Bill of Rights—10 new policies to help out small business. One of the things I've been worried about is how burdened you are with State and Federal paperwork. And a role for the SBA also to ideally take advantage of 21st century technology and have one Web site, where all of your Federal bureaucracy is taken care of—IRS, OSHA, and EPA. What struck me is how many times you have to write your own name on all of these Federal forms—and address and TIN number and everything else. And it should be the mission of the SBA to farm all this data out to the bureaucracy, with a goal of 200 hours per year, maximum, per entrepreneur, to fill out government paperwork. But, can you describe—how much time are you spending now, and—

Mr. CRUZ. In terms of—thank you, Senator Kirk—in terms of the question on the SBA loan, we were very fortunate, where we had a local SCORE office that was very, very helpful, and we used a

company called Growth Corp, who pretty much guided us through the process. And surprisingly, it was very seamless. And it wasn't until after we received the loan and we actually did the construction that I realized, speaking with other people that had tried to obtain an SBA loan, the amount of work and paperwork that they went through, that some of them even gave up. So, I'm—I was very fortunate, where I didn't have that much trouble. And meeting with Mrs. Mills last year, and thanking her for that, she had said that's one of the initiatives that the SBA is working on is, to try to make it easier for businesses, paperworkwise.

ATTRACTING INVESTMENT BY MAJOR RETAILERS

Senator KIRK. Right. Calvin, You've got a big-box store, here. And so, I am totally impressed with what you've done, and think you should keep on going. But, there are a lot of people in Chicago that say, "A Walmart shouldn't come into the community." What do you think of this view that some big boxes are okay and some big boxes—and does that hurt your ability to attract new investment and exactly what you've done?

Mr. HOLMES. So, I knew one of you would give me a very tough question. And I'm not sure I'm in a position to speak to whether or not we should have unions, or not. I can tell you that a number of our constituents really do believe in livable wages. And the union question is a—

Senator KIRK. So, you shouldn't—

Mr. HOLMES [continuing]. Big part of that.

Senator KIRK. You should not be allowed to work with a Walmart, is what you're saying.

Mr. HOLMES. What we do is not finance the big national retailers, per se. We actually finance the developer who's going to bring the brick and mortar envelope to the site for that retailer.

Senator KIRK. Would this have been a bad idea, if Walmart had come?

Mr. HOLMES. We think that it's important to have a wide variety of high-quality goods and services in working class communities, Senator Kirk.

Senator KIRK. Right.

Mr. HOLMES. And we understand that there is a range of national and regional and chainlets that can do that. We are in a community of people who are incredibly concerned about making sure that there are employers who will pay a fair and decent wage to working class families. Some of the retailers are really questionable in that respect. So, there are lots of things that we're trying to get our arms around. At the end of the day, we want a healthy mix of retailers in working class communities.

Senator KIRK. One of the other arguments against big boxes is, all the little retailers on all the other streets who would oppose a Target coming in. How did you handle that?

Mr. HOLMES. I can tell you, I don't have the exact quote, but there is a small business owner who owned a salon just a couple of blocks to the north of the Target store, near the Wilson "L" stop, and her last name actually happens to be the same as mine. And she said, when we were at the grand opening with Mayor Daley, that she welcomed the Walmart sorry, not the Walmart—the Tar-

get—because she saw it as an economic engine that was going to increase the foot traffic in the general vicinity. Therefore, she thought she would benefit from having the national retailer so close to her store.

Senator KIRK. I think that's exactly the point. I think the big boxes can totally transform a neighborhood. So, I think what you've done is exactly right. And I'm hoping that we don't have "politically correct" tests. My hope is that your job is economic development, and we keep it on that, without the SEIU or other unions coming in, saying that you cannot work with a certain party who would bring another \$150 million into another neighborhood.

Thank you, Mr. Chairman.

FAMILY-OWNED SMALL BUSINESS AND SBA LENDING

Senator DURBIN. Mr. Cruz, if I'm not mistaken, I met your mother and father at a luncheon in Chicago. And I just want to make sure that, although your father receives a great deal of credit, that your mom is also acknowledged.

If you'd like to say a word about her role in the development of your business.

Mr. CRUZ. Thank you, Senator Durbin. My parents wanted to come here so badly, to be part of this, to witness this. My mother and father did, together, start this business. And as a child—I have three sisters, and I remember—there was a time where they were in their—in our small home with a small garage, and both of them were cleaning furniture after smoke damage—thinking that these two people are my heroes. And I will share your compliments with them. Thank you for asking.

Senator DURBIN. If I remember correctly, your dad came to this country with limited English skills and went to work at this business and, when the owner finally decided to give it up, offered it to your father. And that's what launched where you're sitting today.

Mr. CRUZ. That's correct.

Senator DURBIN. It's a great, great story. How did you find out about this SBA program?

Mr. CRUZ. Well, my conventional banker had mentioned the process to me. And 4 years previous, probably 5 years previous, we had started to fill out an application to see if we would be able to obtain an SBA loan. And, like I had said to Senator Kirk, the paperwork was unbelievable. So, I went to a local SCORE office, and they gave me a bunch of literature, and read it, and then found—

Senator DURBIN. For the record, tell us what SCORE is. I know, and I think most of the members do. But, let's put it in the record.

Mr. CRUZ. SCORE are local offices that share information about helping your businesses grow, and specifically the SBA and the different programs—

Senator DURBIN. These are retired

Mr. CRUZ [continuing]. That they—

Senator DURBIN [continuing]. Executives—

Mr. CRUZ. Correct.

Senator DURBIN [continuing]. That give you—

Mr. CRUZ. Correct. Ex-business owners. So, it was very great, talking with them, because they understood our challenges and the

time that we didn't have to fill out all the paperwork, and what we needed to do to make it happen. They introduced us to an office that specialized in SBA loans. And again, it was seamless, this what we were able to do is amazing. And I'm extremely grateful to the program.

ADDITIONAL COMMITTEE QUESTIONS

Senator DURBIN. Great. Thank you very much.

I want to thank the entire panel. It's terrific to hear, firsthand, your experience with these Federal agencies, and demystify some of this regulatory gobbledygook, and put it into real life terms. Thank you very much for that.

And we may have some follow-up questions. We'll get back in touch with you.

[The following questions were not asked at the hearing, but were submitted to the Department for response subsequent to the hearing:]

QUESTIONS SUBMITTED TO DONNA J. GAMBRELL

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

Question. Treasury's fiscal year 2010 Performance and Accountability Report states that the Community Development Financial Institutions (CDFI) Fund awardees created or maintained more than 80,000 jobs through loans and investments in fiscal year 2010 compared to the 2008 level of 29,500. As Federal CDFI funding has grown, the program has been able to maintain and actually improve on job creation per Federal dollar spent. Between fiscal year 2008 and fiscal year 2010, funding increased by 250 percent, but job creation increased by 275 percent.

Does the CDFI Fund rely on CDFI self-reporting to determine job creation estimates? Does the CDFI Fund audit awardees after the fact to verify this data and track program outcomes? How else does the CDFI Fund hold awardees accountable after awards are made?

Answer. Each CDFI program awardee is required to sign an assistance agreement prior to receiving an award, which provides the terms and conditions of the award use. Failure to meet the terms and conditions may cause the CDFI Fund to impose one or more sanctions, which may include requiring the awardee to return award funds.

CDFI program awardees are required to self report on their financial performance and community impacts, including job creation estimates¹ annually for a 3-year period following receipt of the award. Award recipients report their annual performance through a Web-based reporting system, the Community Investment Impact System (CIIS). Each awardee has 180 days from its fiscal year end to report key financial performance and community impact data through CIIS. This allows the awardee to complete and support its annual audit and enables the CDFI Fund to verify reported information through desk reviews against the organization's audit.

The CDFI Fund collects full-time equivalent (FTE) data through annual Institution Level and Transaction Level reports. Data is provided by awardees, based on the source² listed for their estimates; the data are compared to benchmarks derived from Federal statistical agencies (e.g., Bureau of Labor Statistics) for accuracy and "reasonableness" as defined by the CDFI Fund.

The annual reports filed by awardees detail an organization's financial position, current assets and liabilities, summary of income and expenses, loan purchases and sales, lending and financing activities, portfolio-at-risk, populations, and geography served by target markets, community impacts including job creation and businesses

¹Jobs maintained are jobs at the business at the time the loan or investment is made. Jobs created are new jobs created after the loan or investment is made. Total jobs are computed as FTEs based on at least a 25-hour work week. Part-time employees are combined to FTEs.

²Source of job estimates includes new hires as a result of the financing; estimates based on State or local wage data; estimates based on economic impact modeling systems (i.e., IMPLAN, RIMSII, or REMI); real estate developer estimates about jobs created by type of business and square-footage built; or other sources.

financed, development services, depository offerings, award compliance, and summary ratios used for compliance monitoring.

In past years, CDFI Fund awardees were measured on their ability to increase total assets. While growing assets may illustrate a healthy financial institution, it is critical to know that CDFIs are using their resources to make loans and investments in distressed communities. Beginning this year, awardees are now measured by the number and amount of loans originated during the fiscal year, not the total portfolio outstanding on their books. This helps the CDFI Fund hold awardees accountable for their ability to continually deploy capital each year of the reporting period.

Question. The statute authorizing the CDFI Fund requires that financial assistance awards be matched with funds from sources other than the Federal Government on a one-to-one basis. However, for fiscal year 2009 and fiscal year 2010 CDFI Fund awards, our appropriations bill waived the matching requirement due to the tightening of the credit markets and difficulty in raising funds from philanthropic sources. For fiscal year 2012, the administration requests to reinstate the matching fund requirement for CDFI Fund programs.

Has the economy recovered to the point where the private sector and philanthropic community is now more able to contribute matching funds to enable greater leveraging of public resources?

Would reinstating the matching fund requirement disadvantage CDFIs in the most distressed communities?

Answer. For decades, CDFIs have met the challenge of providing access to capital and credit in communities impacted by economic turbulence. For fiscal year 2012, the CDFI Fund does not recommend waiving the matching fund requirement for CDFI programs. While Treasury realizes that challenges raising private sector matching funds may exist, matching funds address several related objectives. First, private matching funds multiply the impact of scarce Federal funds. A one-to-one match means that each Federal \$1 generates \$2 for CDFIs and cuts the Federal cost of job creation, affordable housing development, and other community benefits in half. Second, CDFIs use the match requirement to attract private sector contributions. The Federal match encourages private support. Third, private match provides external validation that a CDFI applicant has the capacity to forge partnerships with the private sector. Private providers of matching funds have independently vetted the applicant and demonstrated their support with money. Fourth, a private source of matching funds is more likely to stay involved with a CDFI, often in ways that go beyond the funding itself.

Because demand for the program in recent years has been so competitive, the administration believes that those CDFIs that receive awards from the CDFI Fund will be able to honor the match requirement for fiscal year 2012. However, the administration realizes that many challenges still remain for CDFIs to raise the private sector matching funds that could prevent some CDFIs from applying. While it is likely that the CDFI Fund will not receive as many applications by reinstating the match requirement, the CDFI Fund believes that this is the most responsible way to handle the trust placed by the Congress to provide grants to the highest-qualified applicants.

SUBCOMMITTEE RECESS

Senator DURBIN. I thank those who attended this hearing.

At this point, the hearing stands recessed.

[Whereupon, at 11:20 a.m., Thursday, May 25, the hearing was concluded, and the subcommittee was recessed to reconvene subject to the call of the Chair.]

MATERIAL SUBMITTED SUBSEQUENT TO THE HEARING

[CLERK'S NOTE.—The following testimonies were received subsequent to the hearing for inclusion in the record.]

PREPARED STATEMENT OF THE COMMUNITY DEVELOPMENT BANKERS ASSOCIATION

The members of the Community Development Bankers Association (CDBA) thanks Chairman Durbin and Ranking Member Moran for the opportunity to submit testimony on the Obama administration 2012 budget request for the Community Development Financial Institutions (CDFI) Fund of the Department of the Treasury. We thank you for your past support of the CDFI Fund, the community development finance sector, and the Low and Moderate Income (LMI) people and communities we serve.

We strongly urge you to support the President's budget request of \$227 million for the CDFI Fund. CDBA is the national trade association of the community development bank sector. We are the voice and champion of banks and thrifts with a mission of serving LMI people and communities.

Currently there are 91 certified CDFI banks with approximately \$28.3 billion in aggregate total assets and a median asset size of approximately \$200 million.¹ While we account for less than 10 percent of the total number of CDFIs we comprise approximately 50 percent of the total assets of the CDFI industry.

CDFI banks are regulated FDIC-insured financial institutions subject to the same standards and regulatory scrutiny as other traditional banks. Yet, we are distinctively different as demonstrated by our track record of commitment to our communities. All of CDBA's members have been certified by the Department of the Treasury as CDFIs, meaning at least 60 percent of their total activities are targeted to LMI communities—with most targeting significantly more of their resources to these areas. As documented by analysis of the National Community Investment Fund (NCIF)², significantly more of our lending and service activity is concentrated in low- to moderate-income communities than traditional financial institutions.

CDFI banks provide financing that is catalytic in sparking economic activity within their communities. For example:

- The Central Bank of Kansas City is financing an exciting economic revitalization project in the long-neglected Rainbow Corridor of Kansas City, Kansas. 39Rainbow is a 26,000+ square foot mixed-use retail, residential, and hotel development that will create hundreds of jobs and serve as an anchor to spark the revitalization of the surrounding neighborhood. The project has strong civic support with the city of Kansas City (KS) and State of Kansas providing tax and development incentives to promote investment in the urban core.
- The Pan American Bank helped the Velez family grow their small wholesale seafood business—which serves food product retailers in Chicagoland. Pan American financed El Ray Seafood's expansion to larger facility and it has now grown to employ eight people.
- The International Bank of Chicago enabled the Trinh family to expand their tofu and bean sprout production business through a loan to buy a warehouse in a low-income Chicago neighborhood. The business couldn't fully respond to customer demand due to the limited size of their facility. Now settled into their new facility, they have just hired two additional employees.
- Southern Bancorp helped stabilize and expand Strohm Manufacturing located in Clarksdale, Mississippi, one of the poorest counties in the South. Following the death of the founder and increasing global competition, Strohm struggled

¹SOURCE: FDIC call report data at March 3, 2011.

²National Community Investment Fund's annual Social Performance Metrics analysis (see <http://www.ncif.org/>).

to stay in business. Southern Bancorp helped restructure this family's business debt and provided them with a line of credit. Strohm now employs 10 people. Illinois is home to 43 certified CDFIs—of which 16 are CDFI banks. Illinois CDFIs have received more than \$115.5 million in support from the CDFI Fund since 1996. This Federal money has been absolutely critical to combating long-term poverty, unemployment, and social ills of too many Illinois communities and citizens. Loss of—or reductions in—funding for the CDFI Fund will have a direct and immediate impact on our ability to serve our communities and facilitate economic recovery and job creation.

Since 1996, hundreds of CDFIs and banks have participated in the programs of the CDFI Fund. The programs of the CDFI Fund have a proven, documented track record of creating impact and have become invaluable in helping banks find ways to serve credit markets and communities that otherwise might not be served. The programs of the CDFI Fund use very modest public resources to leverage large amounts of private dollars. Analysis by the Treasury Department estimates that the leverage factor is as high as 20 to 1. This finding makes the CDFI Fund one of the smartest investments of Federal resources to solve some of the Nation's most critical economic problems. The CDFI Fund is truly one of the Federal Government's best market-based strategies for leveraging and channeling needed resources to our most challenged communities.

CDBA wholeheartedly supports all of the CDFI Fund's programs. The CDFI Fund's Bank Enterprise Awards (BEA) program is particularly important to CDFI banks and the communities they serve; it supports new investment in CDFIs of all types and provides resources to reach the most underserved communities. BEA resources are well-targeted to the neediest communities by requiring that direct lending and services be targeted to places with at least 30 percent poverty and 1.5 times the national unemployment rate. BEA is also focused on the smallest and most mission-focused banks. In fact, since 2007, CDFI banks have received 78 percent of all BEA awards and the smallest banks (with less than \$250 million in total assets) have received more than 57 percent of all funding. Of the \$227 million requested in the President's budget, we ask that at least \$22 million be reserved for the BEA Program.

We fully recognize that Federal appropriators face great challenges this year. But, as you know, low-income families and communities are among the hardest hit during periods of economic distress. This recession has been no exception. The CDFI Fund has already endured a \$20 million cut in funding between fiscal year 2010 and fiscal year 2011. In the interests of promoting new jobs and economic recovery in the hardest hit rural and urban communities of our Nation, we urge you to maintain fiscal year 2011 funding levels of \$227 million for the CDFI Fund in fiscal year 2011. Any further reductions in the CDFI Fund's appropriations will directly result in the loss of jobs, affordable housing, and small business credit that will be felt across the Nation in the places that need it most.

We strongly urge you to support continued funding at the fiscal year 2011 level and as requested in the President's budget.

We thank Chairman Durbin, Ranking Member Moran, and the members of the subcommittee for the opportunity to express our views.

LETTER FROM WOMEN IMPACTING PUBLIC POLICY

MAY 18, 2011.

Hon. RICHARD J. DURBIN,
Chair, Subcommittee on Financial Services and General Government,
Washington, DC.

DEAR SENATOR DURBIN: We are writing to express our views on the Small Business Administration's (SBA) proposed budget for fiscal year 2012. Women Impacting Public Policy (WIPP) supports funding for programs and services that benefit the women-owned business community including the Women's Procurement Program, Women Business Centers (WBCs), and SBA's Office of Advocacy. WIPP is a national, nonpartisan organization representing 54 organizations and more than 500,000 women business owners nationwide.

WIPP supports the proposed \$1 million funding for the Women Owned Small Business Federal Contract program included in the President's proposed budget. This program, which has taken 11 years to enact, is designed to give women-owned businesses greater access to Federal contracting. It will allow contracting officers, for the first time, to restrict competition for Federal contracts to women-owned businesses. This program will also assist Federal agencies with reaching the Federal goal of awarding at least 5 percent of contracts to women-owned businesses. Central

to the success of this program are procurement center representatives (PCRs), breakout procurement center representatives (breakout PCRs), and commercial marketing representatives (CMRs). We supported increased funding for PCRs, breakout PCRs, and CMRs because of their importance in ensuring small business participation in the procurement process.

In addition, we support the proposed \$14 million in funding for Women Business Centers (WBCs). WBCs provide essential training, counseling, and mentoring to help women looking to start or grow a successful business. According to the SBA's Office of Entrepreneurial Development (ED) 2010 Impact Report, WBC's clients who received 3 or more hours of counseling reported a 47 percent increase in sales while clients who received less than 3 hours of counseling reported only a 36 percent increase in sales. Businesses that receive assistance from WBCs have significantly higher survival rates than those businesses not receiving similar support.

WIPP also supports the Microloan and technical assistance (TA) programs at the SBA. These programs support entrepreneurs and small businesses seeking grow their businesses in underserved communities across the country. In addition, we support continuing the PRIME program, which is the only major program designed to provide TA funding to intermediaries which are not lenders.

Last, we support funding for the Office of Advocacy. WIPP supports the President's recommended funding of \$9,120,000 for SBA's Office of Advocacy. Small businesses need to have an independent voice in Federal regulatory process.

We urge you to support funding for these important programs.

Sincerely,

BARBARA KASOFF,
President.

FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2012

WEDNESDAY, JUNE 8, 2011

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 10:31 a.m., in room SD-138, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.

Present: Senators Durbin, Moran, and Kirk.

DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

STATEMENT OF HON. DOUGLAS H. SHULMAN, COMMISSIONER

OPENING STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. Good morning. I'm pleased to convene this hearing to consider the fiscal year 2012 funding request for the Internal Revenue Service (IRS). It's the largest single account within our subcommittee. Our focus today is on the President's budget request for the IRS. The \$13.6 billion in annual funding constitutes more than one-half the total amount of discretionary funding under our jurisdiction.

I'm pleased to share the dais with my friend and distinguished ranking member, Senator Moran of Kansas, and other Members will probably join us.

Joining us today to present testimony about the resource needs of the IRS is the Honorable Douglas H. Shulman, now in his fourth year of a 5-year term as the 47th Commissioner of the IRS.

Thanks for your service and for accepting the challenge to help lead the IRS from good to great. I welcome the opportunity to conduct a critical oversight of the IRS and its programs through our discussion today.

The Congress exercises its most-effective oversight of agencies and programs through the appropriations process. It allows for an annual check-up and review of operations and spending.

To complement congressional oversight, the IRS has a cadre of important watchdogs and keen observers, including J. Russell George, Treasury Inspector General for Tax Administration; Nina E. Olson, the National Taxpayer Advocate; Paul Cherecwich, Jr. Chairman, IRS Oversight Board; the U.S. Government Account-

ability Office (GAO); and Colleen M. Kelley, national president, National Treasury Employees Union (NTEU). Lots of people are watching. I appreciate the exemplary work and constructive contributions of each of these entities to help us prepare for today's hearing.

The IRS administers the tax laws and collects revenues that fund more than 96 percent of Federal Government operations. Each year the 95,000-plus employees of the IRS make hundreds of millions of contacts with American taxpayers and businesses.

The IRS represents the face of Government to more U.S. citizens than any other agency of Government.

On a budget in this fiscal year of \$12.15 billion, the IRS collected \$2.345 trillion in taxes—93 percent of all Federal receipts. That's \$194 in revenue for every \$1 of appropriated funds given to run this agency. They processed 230 million tax returns, including 141 million individual returns, 7 million corporate, and 30 million employment tax returns. They issued 109.5 million refunds worth \$366 billion, and the list goes on.

For fiscal year 2012, the President's budget request for funding of \$13.2 billion represents an overall increase of \$1.1 billion, or about 9.4 percent more than the fiscal year 2011 level. For the IRS accounts, the fiscal year 2011 enacted bill maintained funding at the same level as provided in fiscal year 2010. I recognize that such a level falls more than \$487 million short of what the President had requested for this year, so there has been belt tightening all around, and it's affected your agency.

PREPARED STATEMENT

We will talk today about the budgetary challenges which you face in the upcoming year, some of the policy challenges which drive spending in your agency, and I look forward to hearing more about the challenges the IRS faces in these difficult budgetary times.

[The statements follow:]

PREPARED STATEMENT OF SENATOR RICHARD J. DURBIN

Good morning. I am pleased to convene this hearing to consider the fiscal year 2012 funding request of the Internal Revenue Service (IRS), the largest single account within the Senate Appropriations Subcommittee on Financial Services and General Government.

Our focus today is on the President's fiscal year 2012 budget request for the IRS. The \$13.6 billion in annual funding for the IRS alone constitutes just more than one-half of the total amount of discretionary funding under the jurisdiction of this subcommittee.

I am pleased to share the dais with my distinguished ranking member, Senator Jerry Moran, and other members of the subcommittee.

Joining us today to present testimony about the resource needs of the IRS is the Honorable Douglas H. Shulman, now in his fourth year of a 5-year term as the 47th Commissioner of the IRS. Thank you for your service and for accepting the challenge to help lead the IRS from "good to great".

I welcome the opportunity today to conduct critical oversight of the IRS and its programs through a candid discussion of where the agency is today, where it needs to be, and how we can ensure that the IRS has the necessary resources to fulfill its important missions.

The Congress probably exercises its most effective oversight of agencies and programs through the appropriations process. It allows an annual check-up and review of operations and spending.

To complement congressional oversight, the IRS has a cadre of important watchdogs and keen observers monitoring and evaluating its operations. These include the Treasury Inspector General for Tax Administration (TIGTA); the National Taxpayer Advocate, the IRS Oversight Board; the Government Accountability Office; and the National Treasury Employees Union.

I appreciate the exemplary work and constructive contributions of each of these entities to help critique, guide, promote, and improve the work of the IRS. I invited top officials of each of these organizations to submit written materials to enrich the subcommittee's work and augment the record of these proceedings today.

I ask unanimous consent that the statements and accompanying materials received by the subcommittee be made a part of the permanent record of this hearing.

ACCOMPLISHMENTS OF THE IRS

The IRS administers the tax laws and collects the revenues that fund more than 96 percent of Federal Government operations and public services.

Each year, the 95,425 employees of the IRS make hundreds of millions of contacts with American taxpayers and businesses. The IRS represents the face of Government to more U.S. citizens than any other agency.

During fiscal year 2010, the IRS:

- On a budget of \$12.15 billion, collected \$2.345 trillion in taxes—93 percent of all Federal receipts. That's \$194 in revenue for every \$1 in appropriated funds.
- Processed 230 million tax returns, including 141 million individual returns, 7 million corporate returns, and 30 million employment tax returns.
- Issued 109.5 million refunds worth \$366 billion.
- Spent an average of 53 cents to collect each \$100 of tax revenue.
- Examined more than 1.58 million individual income tax returns (an 11 percent increase more than fiscal year 2009) and nearly 30,000 returns filed by corporations.
- More than doubled its offshore presence—adding offices in Asia and Central America, boosting law enforcement staffing throughout the globe, and expanding interaction with international organizations—all designed to investigate and crack down on tax absconders wherever they may be.
- Increased automated under-reporter contact closures to more than 4.3 million—a 19.8 percent increase more than fiscal year 2009—and surpassing the 4 million mark for the first time.
- Provided taxpayer assistance through 305 million visits to the IRS.gov Web site (double the volume in 2004)—responding to the growing demand for electronic tools and online access to information.
- Answered 47 million calls to customer service phone lines.
- Assisted more than 78 million taxpayers through its telephone helpline or at walk-in sites.
- Received 35.1 million automated calls, a 21 percent uptick from fiscal year 2009, reflecting rising demand for self-service options.

THE BUDGET REQUEST

For fiscal year 2012, the President's budget requests funding of \$13.284 billion, representing an overall increase of \$1.138 billion, or 9.4 percent, above the fiscal year 2011 enacted level of \$12.146 billion under the continuing resolution enacted on April 15 to cover the balance of this fiscal year.

For the IRS accounts, the fiscal year 2011 enacted bill maintained funding at the same level as provided in the fiscal year 2010 enactment. I recognize that such level falls more than \$487 million short of what the President requested for this year.

While my preference would have been to fund the IRS at the level recommended in our July 2010 Committee-reported bill, I regret to say that we faced a significant reduction in our available discretionary resources.

In fact, our overall allocation cap was 10 percent below the fiscal year 2010 enacted level, compelling some difficult negotiations and funding decisions to finish the fiscal year 2011 bill this spring. I am pleased we were able to avert the troubling \$603 million cut below fiscal year 2010 for the IRS that was included in the House-passed H.R. 1.

The fiscal 2012 funding forecast is, to put it mildly, bleak. This subcommittee faces grim prospects and challenging funding decisions for the ensuing fiscal year, and beyond. It will be helpful to hear Commissioner Shulman's honest appraisal of the resource needs that the IRS will require to achieve its dual mission of:

- Providing America's taxpayers with top quality service by helping them understand and meet their tax responsibilities; and
- Applying the tax law with integrity and fairness to all.

I look forward to hearing more about the particular challenges the IRS faces in these lean budgetary times, and how this subcommittee can be helpful in supporting the mission of the IRS.

Now I'd like to turn the floor over to my colleague, Senator Moran.

STATEMENT OF SENATOR JERRY MORAN

Senator MORAN. Chairman Durbin, thank you. Thanks for the hearing today.

Welcome, Commissioner Shulman.

I understand that the IRS is tasked with enormous responsibilities. The IRS collects the revenue that funds Government and administers our tax laws.

The IRS's goal of improving services, making voluntary compliance easier, and enforcing the laws to ensure that everyone pays their fair share of taxes, is all laudable. I also believe we would all agree that we should make sure that our tax code and the IRS compliance and enforcement efforts don't make it even harder for taxpayers and small businessmen and women to meet their tax obligations.

As we know, the American economy is facing very difficult times, and we need to get the country's economy moving again. Americans are struggling, and overly burdensome regulations and reporting requirements hamper the ability of our Nation's small businesses to grow their businesses and create jobs.

I was very pleased to see the Congress address some of the uncertainty by passing legislation to repeal the costly and unprecedented 1099 tax reporting mandate in the new healthcare law. This marks a significant change in our healthcare law, and that repeal of the 1099 requirement is good news for small business and agriculture producers, who bear the largest burden under these provisions. I am interested in talking to you, Mr. Commissioner, about the consequences of that repeal on your appropriations and budget request.

I note that the President's request for the IRS for fiscal year 2012 is almost \$13.3 billion. This is an approximate \$1.1 billion more than the 2010 enacted level and the fiscal year 2011 level, resulting in a 9 percent increase. Almost half a billion of that increase is requested to begin implementation of the new healthcare law. Given the current fiscal reality, I am interested to learn how the IRS intends to prioritize its goals and carry out its core responsibilities of enforcement and taxpayer services and make progress on important information technology projects.

I appreciate the significant and complex responsibilities that the IRS faces. Given our Government's fiscal constraints, we must carefully review all agency budget requests to ensure taxpayers are receiving the best value for their dollars. We must make sure that we address our country's economic problems in a fiscally responsible way.

Mr. Chairman, I look forward to hearing the testimony, and I thank you for calling the hearing and look forward to working with you on the subjects within this subcommittee's jurisdiction.

Senator DURBIN. Thanks a lot, Senator Moran. And, Mr. Shulman, the floor is yours.

SUMMARY STATEMENT OF HON. DOUGLAS H. SHULMAN

Mr. SHULMAN. Thank you, Chairman Durbin and Ranking Member Moran. It's good to be here, and I appreciate the opportunity to testify about our 2012 budget.

This budget was crafted during a time of fiscal austerity and belt tightening for the Nation, and it's incumbent upon all of us in Government to be as efficient as possible and to spend taxpayer dollars wisely. This means, in my mind, finding savings where we can, and continuing to invest in strategic priorities that allow us to improve service and voluntary compliance.

The fiscal year 2012 budget includes almost \$190 million in efficiency savings and reductions, and you've got my commitment to continue to look for ways to save the Federal Government money.

Against this backdrop, it's also clear that the IRS is vital to both the functioning of the Government and keeping our Nation and economy strong. In fiscal year 2010, the IRS collected, as the chairman noted, \$2.345 trillion in gross revenues to fund the Federal Government, which is approximately 93 percent of all Federal receipts. For every \$1 spent on the IRS, we collect approximately \$200 of revenue.

Mr. Chairman, one of our core duties, as you noted, is conducting the filing season. Despite late tax law changes, this filing season actually went relatively smoothly. As of the end of May, we had gotten about 133 million individual returns. We issued more than 100 million refunds, totaling \$285 billion. We've also answered more than 50 million taxpayer calls this year.

The IRS e-file program, which is lauded by many as one of the most successful modernization programs in all of Government, continues to show growth. This year, we reached two very major milestones. One is, for the first time ever, we had 100 million people electronically file. And this year—we started the e-file program in 1986—we crossed the 1 billionth electronic filing of a tax return this year. Clearly it's changed the way Americans interact with the IRS.

This is also a big deal for efficiency. It costs us 17 cents to process an electronically filed return. It costs us \$3.66 to process a paper return. And we've been reaping benefits and downsizing our operations ever since e-file started.

Let me also note that we continue to try to help taxpayers who are struggling to regain their footing after the recession. This year, we started something we call our Fresh Start program, which expands our Offer in Compromise program. It made lien withdrawal easier for taxpayers, it made it easier for small businesses to enter an installment plan, and it changed our lien criteria.

Now, in recognition of the critical role that we play in the economy—both helping taxpayers file their taxes and also collecting the revenue—the President asked for judicious investments in IRS in the 2012 budget. These investments reflect our balanced approach to both taxpayer service and compliance programs, and our commitment to administer the tax laws in a balanced and fair manner.

It also includes funding to finish, for the 2012 filing season, our key core account database. If and when we've a fully operational account database, it will mean faster processing of returns, expe-

dited refunds for all Americans, better customer service, and enhanced data security.

I also want to emphasize that, because of our unique revenue collection function, all of the investments in the IRS more than pay for themselves by generating much more revenue than they cost.

Mr. Chairman, I would be remiss if I did not mention for a moment the House budget resolution, which provided a funding level for the Financial Services and General Government Subcommittee of approximately \$2 billion below the fiscal year 2011 enacted level. Because, as you mentioned, we're the majority of the Financial Services and General Government bill, cuts of this magnitude would be substantial and affect all of IRS operations—from answering taxpayer questions on the phone to front-line compliance activities, such as audit coverage.

Because the lost revenues from reduced tax law enforcement, cuts such as those in the House budget resolution would actually increase the deficit by decreasing revenues. In addition, conspicuous drops in our enforcement activities could have an impact on longer-term voluntary compliance in the country.

PREPARED STATEMENTS

So let me conclude by just saying, I recognize that we are in a very challenging fiscal environment, and that there's going to be a lot of difficult choices that you and your colleagues are going to need to make. I look very much forward to a constructive dialogue over the weeks and months ahead with this subcommittee, and very much appreciate the support that this subcommittee has given the IRS.

[The statement follows:]

PREPARED STATEMENT OF DOUGLAS H. SHULMAN

INTRODUCTION AND SUMMARY

Chairman Durbin, Ranking Member Moran, and members of the subcommittee, thank you for the opportunity to appear today to discuss the President's fiscal year 2012 budget request for the Internal Revenue Service (IRS).

This budget was crafted during a time of fiscal austerity and belt tightening for the Nation and it is incumbent upon all of us in Government to be as efficient as possible and spend taxpayer dollars wisely. That means finding savings where we can, and continuing to invest in strategic priorities that allow us to continuously improve.

Against this backdrop, it is clear that the IRS is vital both to the functioning of Government and keeping our Nation and economy strong. In fiscal year 2010, the IRS collected \$2.345 trillion in gross revenue to support the Federal Government, approximately 93 percent of all Federal receipts. Moreover, for fiscal year 2010, we processed more than 140 million individual income tax returns and issued 109.5 million refunds to individual taxpayers totaling \$366 billion.

A Record of Success

Mr. Chairman, the IRS is also proud of its implementation track record over the past few years.

We have run smooth filing seasons for the last several years, despite new tasks being added to our agenda and late passage of legislation.

We have also made good strides in cracking down on international tax evasion. We struck a landmark deal with the Government of Switzerland, and for the first time received information on thousands of Americans hiding assets in Swiss bank accounts. As we turned up the pressure on those not paying taxes on overseas assets, we had approximately 15,000 voluntary disclosures from individuals who came in under our special Voluntary Disclosure Program. Since the special program

closed, we received an additional 4,000 voluntary disclosures from individuals with bank accounts from around the world.

Many of these voluntary disclosure cases involve significant amounts of previously unpaid tax.

However, collecting such substantial additional revenue for past misdeeds is not the only important consideration here. Regardless of dollar size, it is important that we are bringing thousands of U.S. taxpayers back into the system so they properly report and pay their taxes for years to come on their offshore accounts.

In February 2011, the IRS announced a new special voluntary disclosure program designed to help people with undisclosed income from hidden offshore accounts get current with their taxes.

Our goal in our offshore efforts is to fundamentally change the risk calculus of taxpayers. We are well on our way to deterring the next generation of taxpayers from using hidden bank accounts to avoid paying taxes.

We have also been ushering in a new relationship with corporate taxpayers with a major focus on creating forums and venues where we can resolve issues faster and provide more certainty.

The impetus for this new approach stems from the simple shared belief that at the end of the day, taxpayers and tax authorities pretty much want the same thing. They want a balanced tax administration system that provides:

- Certainty regarding a taxpayer's tax obligations sooner rather than later;
- Consistent treatment across taxpayers; and
- An efficient use of Government and taxpayer resources by focusing on the issues and taxpayers that pose the greatest risk of tax noncompliance.

There are several interlocking pieces that will help advance this transformation. It requires more transparency on both sides; a re-tooling of our audit approach; and a commitment to resolving issues quickly and clarifying uncertainty in the law.

We now have a number of innovative, forward-thinking programs and forums, such as our industry issue resolution program, compliance assurance program, fast track settlement, and our uncertain tax positions reporting requirement that are focused as a package on the goals of faster issue resolution and greater certainty for those taxpayers who want to be transparent.

One of the most important initiatives that the IRS has undertaken in recent memory is the return preparer initiative, which is now being implemented. In September 2010, we launched the new online Preparer Tax Identification Number (PTIN) application system. It is up and running with more than 700,000 preparers already registered in the system.

More than just an identification number, the PTIN registration process gives the IRS an important and better line of sight into the return preparer community than we have ever had before. We can leverage that information to help us better communicate, analyze trends, spot anomalies and potentially detect fraud.

The registration process will help us build in several years a publicly accessible database of preparers who are authorized to prepare returns. This is an extremely important tool for consumers as they will be able to search the database to ensure that their preparer is registered. It will also make it easier to find and track the bad actors out there. They will not be able to pull up stakes and move around anonymously.

The IRS is also very proud of its work in implementing the tax-related provisions of the American Recovery and Reinvestment Act (ARRA) and other economic recovery legislation. We put out billions of dollars to help people buy homes and stabilize the housing market through the First-time Homebuyer Credit, and we added \$400 to \$800 to families' paychecks through the Making Work Pay Credit, just to name two provisions.

The IRS continues to provide taxpayers with quality customer service and different service channels and products. They run the gamut from traditional walk-in sites for those who need to see an IRS representative face-to-face, to toll-free automated and assistor telephone service, to Web-based applications and social media. All make it easier for taxpayers to file and pay their taxes.

Telephone level of service has recovered after several challenging years. This year we are targeting a 71 percent assistor level of service for the full year. Toll-free tax law accuracy and accounts remain respectively at 93 percent and 95 percent, and the overall toll-free customer satisfaction rating stood at 92 percent. Last year, we also saw a 70 percent e-file rate for individuals as compared to a mere 10 percent 15 years ago. As noted in the next section, this translates into a huge savings.

IRS.gov has become the favorite source of information for millions of taxpayers. For fiscal year 2010, there were almost 305 million Web page visits to IRS.gov—a 14 percent increase over the same time period in fiscal year 2009. Use of the

“Where’s My Refund” electronic tracking tool continued to post double-digit yearly gains.

The IRS is increasingly communicating with taxpayers who may not get their information from traditional sources, such as newspapers and broadcast and cable news. By employing social and new media, such as YouTube, Twitter and even iTunes, we are able to reach these taxpayers with important service and compliance messages.

In January 2011, the IRS also unveiled IRS2Go, its first smartphone application that lets taxpayers check on the status of their tax refund and obtain helpful tax information.

This new smartphone app reflects our commitment to modernizing the agency and engaging taxpayers where and when they want.

Finally, the IRS continues to run robust compliance programs. We continue to have appropriate and balanced audit coverage rates across taxpayers and to innovate in our collection programs.

And in our latest effort to help struggling taxpayers, the IRS announced on February 24, 2011, a series of new steps to help people get a fresh start with their tax liabilities.

The goal is to help individuals and small businesses meet their tax obligations, without adding unnecessary burden to taxpayers. Specifically, the IRS set forth new policies and programs to help taxpayers pay back taxes and avoid tax liens.

The announcement centers on the IRS making important changes to its lien filing practices that will lessen the negative impact on taxpayers. The changes include:

- Significantly increasing the dollar threshold when liens are generally issued, resulting in fewer tax liens;
- Making it easier for taxpayers to obtain lien withdrawals after paying a tax bill;
- Withdrawing liens in most cases where a taxpayer enters into a Direct Debit Installment Agreement;
- Creating easier access to installment agreements for more struggling small businesses; and
- Expanding a streamlined Offer-in-Compromise program to cover more taxpayers.

In short, despite a quickly evolving taxpayer base and unprecedented demands on IRS resources, the IRS continues to deliver for the American people.

Working Smarter and Greater Efficiencies

The IRS continues to reap the financial benefits of the E-File program, one of the most successful modernization programs in Government. Today, we receive nearly 100 million tax returns electronically. In the past these returns had to be opened, sorted, and transcribed manually. The efficiency savings have allowed us to reduce our submission processing sites in half. This year we are closing our fifth of the original 10 sites that processed paper returns.

The fiscal year 2012 budget request includes almost \$190 million in efficiency savings, reductions, and nonrecurring activities. While these targets are substantial, I am confident that we will meet them and more, by finding cost-savings in our operations wherever we can.

I have also challenged the IRS leadership and indeed, all IRS employees, to take a hard look at their operations and look for potential savings and efficiencies.

Even in a tough budget environment, I am confident that the IRS will continue to deliver value for the American taxpayer and will emerge as a stronger agency in the years to come.

I am particularly pleased with the progress that we are making in achieving efficiencies in our technology operations. The IRS has embarked on a multi-year effort to streamline and standardize processes that will allow for substantial efficiency gains. For example, the Information Technology Infrastructure Library is a collection of best practices used to aid in the implementation of a lifecycle framework for IT Service Management. In September 2010, an independent third party found that the IRS recently reached Capability Maturity Model Level 2 based on established criteria.

Achieving this level allows standardized project management practices across projects. This will improve our agility and quality in delivering software to our business customers and the taxpaying public, as well as reduce the cost of developing and maintaining products, and improve the cost of engineering services.

Investing in Core Programs

Indeed, it is in recognition of the critical role that the IRS plays in the economy that the fiscal year 2012 request includes a judicious investment in the IRS’ core service and enforcement programs and initiatives. Enforcement and customer serv-

ice are not an either/or proposition. Accomplishing our mission requires that we do both well.

The request also includes the necessary funding for completing on time for the 2012 filing season the core taxpayer account database. A fully operational customer account database will mean faster processing of returns, expedited refunds for 140 million individual taxpayers and enhanced data security.

The funding in the President's budget request will be used to carry out the IRS' strategic and balanced agenda that includes:

- Improved service to taxpayers, including enhancements to the IRS.gov Web site to meet taxpayer needs and growing demand for more e-services;
- Robust and targeted enforcement programs to address offshore tax evasion and improve tax compliance for corporate and high-income taxpayers;
- Completion of the new taxpayer account database and enhancements to our electronic filing platforms;
- Leveraging the return preparer program to reduce noncompliance;
- Implementation of our uncertain tax position reporting requirements;
- Combating errors and fraud for refundable tax credits, such as the Earned Income Tax Credit (EITC);
- Better use of data, such as credit card and securities basis information reporting;
- Implementation of new tax provisions found in major recent legislation, including the Affordable Care Act (ACA);
- Workforce development to ensure that we have a talented and capable workforce for the foreseeable future; and
- Enhancing workplace/physical security for IRS employees.

The IRS will also administer those portions of ARRA that were extended into 2011. These include the expanded EITC for families with three or more children and the American Opportunity Tax Credit to help pay tuition and other expenses for individuals enrolled in institutions of higher education. In addition, we continue to administer the Health Coverage Tax Credit (HCTC) that was enacted as part of the Trade Adjustment Assistance Reform Act of 2002.

The new enforcement personnel included in the request will generate more than \$1.3 billion in additional annual enforcement revenue once the new hires reach full potential in fiscal year 2014. The roughly \$6 to \$1 return on investment estimate related to these initiatives does not include the indirect revenue effect of the deterrence value of these investments and other IRS enforcement programs, which is conservatively estimated to be at least three times the direct revenue impact.

ACA

IRS will need to implement and administer the tax provisions of the ACA (Public Law 111-148) in 2012. IRS seeks to be helpful to families and businesses that will benefit from the ACA. In fact, some benefits have already begun. For example, upon enactment of the ACA, IRS immediately began to make sure that small employers were aware of a significant new tax credit to help them provide health coverage to their workers.

Because the tax credit was enacted mid-year, and became effective immediately, IRS conducted a significant outreach campaign to small businesses. In addition to mailing postcards to millions of employers alerting them to the new credit, IRS held or attended more than 1,000 outreach events targeted at small businesses and the tax practitioners who serve them.

Working with the Department of Health and Human Services, we also administered a program to provide \$1 billion in tax credits and grants to qualifying therapeutic discovery projects.

In addition, we have implemented or have begun to implement changes that expanded the tax credit for adoptive parents, a new exclusion for loan forgiveness programs for certain health professionals, and a new excise tax on indoor tanning services.

We are also working diligently to implement the tax law components of the changes made to the health insurance marketplace that will begin in 2014. Let me put these efforts in context by describing the activities that we are undertaking to plan for these upcoming changes.

The IRS also has significant information technology development work that must be completed in order to administer these provisions. The vast majority of the resources that the IRS will require between now and 2014 will be dedicated to technology and the associated business process design required to effectively administer these new provisions.

Exchanges and Medicaid Health Coverage

Individuals seeking subsidized coverage will interact with the IRS at a few discrete points in the process:

Obtaining Coverage Through Exchanges and/or Medicaid.—The ACA outlines eligibility rules for the premium assistance tax credit, as well as Medicaid. In both cases, the household income as reported to the IRS by approximately 140 million taxpayers on the 2012 tax returns will be relevant to eligibility determination. IRS will alter its systems to take account of the new concept of household income, and is planning to provide significant educational tools to help individuals understand what household income represents. Furthermore, planning is underway to determine the best way to provide this information to taxpayers via the Web, telephone, and other channels.

Receiving Advance Premium Tax Credits.—Individuals who are determined to be eligible for the premium assistance tax credit can receive the benefit through advance monthly payments that are made directly to the plan provider. Working with the Treasury Financial Management Service, which will be making the advanced payment, IRS will develop new systems for the administration of the tax credit. In addition, IRS will work with the exchanges as appropriate to ensure there is significant outreach and education to make taxpayers who are receiving the advance payments aware of the importance of reporting mid-year changes in circumstance that could affect their eligibility for, or the amount of the credit.

Reconciling the Premium Assistance Tax Credit With Advance Payments Made Through the Year.—The ACA provides that individuals will reconcile the amount of advance payments of the premium credit with the actual amount as computed on the tax return. In other words, advance payments made throughout 2014 will be reconciled with individuals' tax returns that are filed in the spring of 2015. To the extent that the ultimate credit amount is larger than the sum of the advance payments, the additional amount will be added to the taxpayer's refund. If the ultimate credit amount is lower than the sum of the advance credit, the taxpayer will owe additional tax on the return, potentially subject to a cap.

Individual Coverage Requirement

IRS will also be responsible for administering the requirement that individuals who can afford health coverage either obtain it or make a payment to IRS. While implementation of this requirement does not come into effect until 2014, and will appear on the 2014 tax forms that will be filed in the spring of 2015, we have nonetheless received a number of questions about how this provision will be implemented.

First, we anticipate providing significant outreach and education on this provision. This will come directly from IRS and in partnership with State and Federal agencies, employers, tax return preparers, and others. Our experience in administering new tax laws suggests that the vast majority of individuals will successfully incorporate this provision into their tax year 2014 returns, filed in 2015.

The forms will provide instructions on how individuals can determine if they met the coverage requirement, and if not, how to compute the payment and include it in that year's tax liability. We also plan to work closely with the tax return preparation industry to ensure that the professionals who advise taxpayers are fully informed about this provision. Today, approximately 60 percent of taxpayers use a return preparer and another 25 percent use software to prepare their own returns.

Employer Provisions

Finally, IRS will administer the employer responsibility payment for large employers who do not offer affordable coverage, and have at least one employee who receives subsidized coverage through the exchange. This provision closely intersects with the rest of the exchange provisions, and we are working closely with the Department of Health and Human Services and the Department of Labor to reach out to the employer community, understand what questions and issues they foresee, and incorporate the feedback that we get into the up-front program design and regulatory guidance.

Tax Law Changes

IRS is also working diligently to implement other tax law changes that come into effect over the next several years. Earlier in my testimony I mentioned several that we are already implementing, and would be happy to answer any questions that you have on those, or the provisions coming into effect in the months and years ahead.

CONCLUSION

In conclusion, let me thank the subcommittee again for this opportunity to discuss the IRS budget request for fiscal year 2012 which reflects the progress and improvements the IRS continues to make—even in a difficult budget environment.

I believe the fiscal year 2012 budget is fiscally prudent and makes wise investments in strategic priorities in enforcement, service, and business modernization. It will help ensure that the IRS will continue its vital role in keeping our Nation and economy healthy and strong.

PREPARED STATEMENT OF J. RUSSELL GEORGE, INSPECTOR GENERAL FOR TAX
ADMINISTRATION, DEPARTMENT OF THE TREASURY

Chairman Durbin, Ranking Member Moran, and members of the subcommittee, I thank you for this opportunity to provide a written statement regarding the fiscal year 2012 budget request for the Internal Revenue Service (IRS).

OVERVIEW OF THE IRS'S FISCAL YEAR 2012 BUDGET REQUEST

IRS is the largest component of the Department of the Treasury and has primary responsibility for administering the Federal tax system. Since the Federal tax system is a system that relies upon voluntary compliance, almost everything IRS does in some way relates to fostering compliance with tax laws. IRS provides taxpayer service programs that help millions of taxpayers to understand and meet their tax obligations and administers enforcement programs aimed at deterring taxpayers who are inclined to evade their responsibilities. IRS is charged with vigorously pursuing those who violate tax laws.

IRS must strive to enforce the tax laws fairly and efficiently while balancing service and education to promote voluntary compliance and reduce taxpayer burden. To accomplish these efforts, the proposed fiscal year 2012 IRS budget requested approximately \$13.3 billion¹ in total appropriated resources. The total appropriations amount is an increase of \$1.138 billion, or 9.4 percent, more than the fiscal year 2010 enacted level.

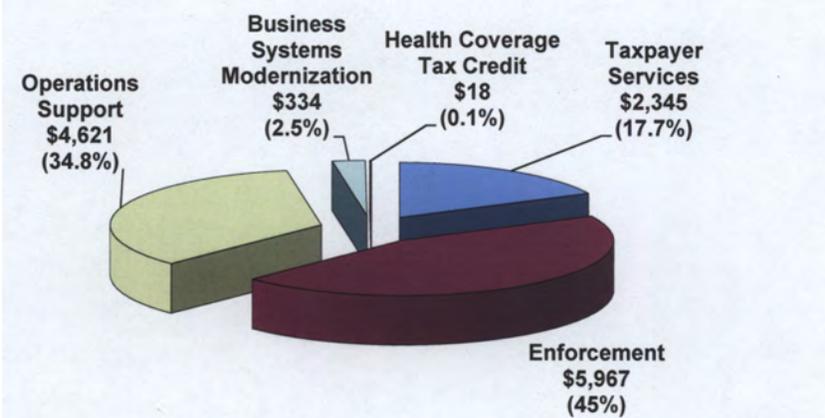
Program Summary by Appropriation Account

IRS fiscal year 2012 budget request includes appropriations for five IRS budget accounts, as depicted in the graph shown:

¹The fiscal year 2012 budget request also includes approximately \$138 million from reimbursable programs and \$204 million from user fees for a total operating level of \$13.6 billion.

**IRS Fiscal Year 2012 Budget Request by Appropriation Account
(in Millions)**

Note: Percentages total more than 100 percent due to rounding.



Generally, these five appropriation accounts fund the IRS's tax administration functions. The three primary appropriation accounts are taxpayer services, enforcement, and operations support. The taxpayer services account funds programs that focus on assisting taxpayers with understanding and meeting their tax obligations, while the enforcement account supports the IRS's examination and collection efforts. The operations support account funds functions essential to the overall operation of the IRS, such as infrastructure and information services. The Business Systems Modernization (BSM) account provides funding for the development of a new taxpayer account database and investments in electronic filing. Finally, the Health Coverage Tax Credit Administration account supports the administration of the Health Coverage Tax Credit.²

The administration seeks to increase funding more than fiscal year 2010 enacted operating levels for all of the appropriation accounts, ranging from 3 to 26 percent increases (see following table). The budget request includes a net increase in IRS staffing of more than 5,100 employees, for a total of more than 100,500 IRS employees.

IRS FISCAL YEAR 2012 BUDGET REQUEST INCREASE OVER FISCAL YEAR 2010 ENACTED BUDGET

[Dollars in thousands]

Appropriation account	Fiscal year 2010 enacted	Fiscal year 2012 request	Dollar change	Percentage increase
Taxpayer services	\$2,278,830	\$2,345,133	\$66,303	2.91
Enforcement	\$5,504,000	\$5,966,619	\$462,619	8.41
Operations support	\$4,083,884	\$4,620,526	\$536,642	13.14
BSM	\$263,897	\$333,600	\$69,703	26.41
Health Insurance Tax Credit Administration	\$15,512	\$18,029	\$2,517	16.23
Total budget appropriated resources	\$12,146,123	\$13,283,907	\$1,137,784	9.37

IRS Fiscal Year 2012 Priorities

The IRS will focus efforts on the following priorities in fiscal year 2012 (these priorities are reflected in multiple appropriation accounts):

²The Health Coverage Tax Credit is a refundable credit for health insurance available to qualified individuals, enacted as part of the Trade Adjustment Assistance Reform Act of 2002, Public Law 107-210, 116 Stat. 933 (2002).

Enforcement.—A serious challenge confronting the IRS is the tax gap.³ Despite an estimated voluntary compliance rate of 84 percent and IRS enforcement actions, a significant amount of income remains unreported and unpaid. IRS estimated the gross tax gap for tax year 2001, the most current figure to date, to be approximately \$345 billion. IRS' strategy for reducing the tax gap is largely dependent on funding for additional compliance resources as well as legislative changes.

In fiscal year 2012, IRS will continue to invest in compliance programs, including its relatively newly enhanced international enforcement initiatives to address offshore tax evasion. These initiatives are designed to address the under-reporting of income associated with international financial activities and expand enforcement efforts to address noncompliance by corporate and high-wealth taxpayers and the complex business enterprises they control (including corporations, partnerships, and trusts). IRS plans to use audit results and intelligence from ongoing offshore initiatives to refine case identification and selection methods to identify promoters, facilitators, and participants in abusive offshore arrangements.

In addition, IRS will continue to pursue other significant initiatives, such as the Compliance Assurance Process program, industry issue resolution projects, and fast track settlements, aimed at earlier and speedier issue resolution and greater efficiency. These initiatives are a major part of the overall retooling of IRS' relationships with large corporate taxpayers.

IRS also plans to continue to implement the recommendations of the Tax Return Preparer Strategy by addressing the challenges associated with the implementation of registration, continuing education, and testing requirements for tax return preparers that are scheduled to go into effect in fiscal year 2011. IRS took a major step forward in launching its new Preparer Tax Identification Number online registration process. The process gives IRS an important and improved line of sight into the return preparer community. IRS plans to use the information to analyze trends, spot anomalies, and potentially detect fraud. In addition, IRS will continue to develop and implement legislation to increase the use of electronic filing among the paid preparer community.

Taxpayer Services.—Assisting taxpayers with their tax questions before they file their tax returns helps prevent inadvertent noncompliance and reduces the need for IRS to send burdensome postfiling notices and other correspondence. In fiscal year 2012, IRS plans to increase its service level by adding resources to meet the ever-increasing demand and by continuing to make efficiency improvements, such as automated self-service applications that allow taxpayers to obtain information on less complicated issues (e.g., refund inquiries). IRS believes that these improvements will allow staff to address the more complex tax-law issues stemming from the passage of new legislation. In addition, IRS continues to study the services it offers to taxpayers on the Internet, at walk-in sites, and on its toll-free telephone lines. IRS officials are also exploring the relationships between taxpayer errors and unclear correspondence to guide them in the development of new approaches to service.

BSM.—Data and technology are central to the future of tax administration. For the 2012 filing season, IRS plans to complete the new taxpayer account database and continue to make investments in its electronic filing systems. Completion of the core taxpayer account database is the cornerstone of IRS modernization that is expected to expedite refunds to millions of individual taxpayers. It is also a prerequisite for other major initiatives, such as the expansion of online paperless services. The ability of IRS to support increasingly complex taxpayer service and compliance initiatives will be severely limited until the new taxpayer account database is completed.

The fiscal year 2012 BSM budget request is \$333.6 million and 453 full-time Equivalents (FTE).⁴ This is an increase of \$69.7 million (26.4 percent) and 120 FTEs more than the fiscal year 2010 enacted level of \$264 million and 333 FTEs. Almost one-half of the budget request will fund continued development of the Customer Account Data Engine 2 (CADE 2).⁵ While the current BSM is

³The Tax Gap is the difference between the estimated amount taxpayers owed and the amount they voluntarily and timely paid each year.

⁴A measure of labor hours in which 1 FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year.

⁵CADE 2 creates a modernized processing and data-centric infrastructure that will enable the IRS to improve the accuracy and speed of individual taxpayer account processing, enhance the

in its 12th year, the IRS' modernization efforts started in the 1980s. IRS originally estimated that the BSM effort would last up to 15 years and incur contractor costs of approximately \$8 billion. To date, the current BSM has received \$3.24 billion in contractor services, plus an additional \$474 million for internal IRS costs.

BSM funding is intended to improve taxpayer service and enforcement, and reduce the costs and risks of operating parallel tax processing systems.⁶ IRS plans to update and settle individual taxpayer accounts in 24 to 48 hours with current, complete, and authoritative data which should facilitate expanded opportunities for compliance, increase analytical capabilities, and accelerate the identification of fraudulent trends.

The increases more than the fiscal year 2010 budget seem reasonable considering the investments in developing and rolling out the CADE 2 during fiscal year 2012. Because the IRS is taking more responsibilities for program management, there are more IRS resources and fewer contractor resources devoted to BSM, thus the increase in labor costs. Finally, the other major BSM projects (e.g., Modernized e-File⁷) have reduced budgets for fiscal year 2012 as they are winding down.

In the area of information technology systems operations, the fiscal year 2012 IRS budget request presents several budgetary increases related to maintaining and improving information technology operations and taxpayer service, including \$33 million to expand online options through IRS.gov improvements, \$25 million for portal migration, and \$27.5 million to update the Integrated Financial System.

The portal initiative funds the second year of a 3-year effort to replace the aging infrastructure of the portals and complete the migration of the two portals by August 2013, when the existing contracts expire. This will result in significant enhancements to online capabilities for tax preparers and other registered users. Failure to complete the portal migration by this date will result in increased portal operating costs and increased risk under existing sole-source contracts. In addition, taxpayer and tax practitioners will continue to use more expensive, labor-intensive service delivery channels such as calling the 1-800 telephone number or visiting an IRS taxpayer assistance center.

Implementation of the ACA

The implementation of the ACA⁸ presents a major challenge to the IRS. ACA represents the largest set of tax law changes in more than 20 years, with more than 40 provisions that amend the tax laws. Although the new law goes into effect gradually over many years, several provisions required immediate action by IRS, including the Small Business Health Care Tax Credit, the Qualifying Therapeutic Discovery Credit, and the expanded Adoption Credit. To enact the range of retroactive provisions, the IRS focused on developing new systems and business processes for near-term provisions, conducting initial planning for long-term provisions, and defining appropriate outreach activities for each affected group.

ANALYSIS OF THE REQUESTED FISCAL YEAR 2012 BUDGET INCREASE

The fiscal year 2012 budget request of \$13.3 billion for IRS is a \$1.138 billion (9.4 percent) increase more than the fiscal year 2010 enacted budget. The \$1.138 billion consists of the following:

Changes to the Base

*Adjustment To Reach Fiscal Year 2011 President's Budget Level*⁹.—Increase of \$402 million, including a \$123 million increase related to the BSM appropriation.

Maintaining Current Levels.—Increase of \$86 million.

Program Reinvestment.—Increase of \$1.5 million (one-time cost).

customer experience through improved access to account information, and increase the effectiveness and efficiency of agency operations.

⁶The IRS operates parallel tax processing systems that require updates to all systems when tax legislation is changed or updated. These parallel systems include CADE, CADE 2, and the Individual Master File.

⁷The Modernized e-File project develops the modernized, Web-based platform for filing approximately 330 IRS forms electronically, beginning with the U.S. Corporation Income Tax Return (Form 1120), U.S. Income Tax Return for an S Corporation (Form 1120S), and Return of Organization Exempt From Income Tax (Form 990). The project serves to streamline filing processes and reduce the costs associated with a paper-based process.

⁸Public Law 111-148, 124 Stat. 119.

⁹The initiatives included in the fiscal year 2011 budget submission are separate from the \$839 million in program increases included in the fiscal year 2012 budget submission.

These increases are offset by a decrease of \$190 million in efficiencies and savings, including a \$1 million decrease related to the modernization appropriation.

Program Changes

Program Increases.—Increase of \$839 million, including an increase of \$52 million in the operations support appropriation for costs related to maintenance of deployed modernization systems. This \$52 million increase is offset by a corresponding decrease of \$52 million in the modernization appropriation for fiscal year 2012.

Adjustment To Reach Fiscal Year 2011 President's Budget Level

IRS is requesting about \$402 million to reach the fiscal year 2011 President's budget request adjusted for the proposed pay freeze. IRS has not issued new guidance for the fiscal year 2012 budget regarding the impact of the full-year fiscal year 2011 continuing resolution signed by the President on April 15, 2011. Therefore, we are presenting the information as reflected in IRS' fiscal year 2012 budget request dated February 14, 2011.

The fiscal year 2012 budget request does not specify which initiatives are included in the \$402 million increase. However, we reviewed IRS' fiscal year 2011 budget request, and identified the following program changes in addition to changes to the base:

- \$21 million to increase the telephone level of service;
- \$25 million to improve and redesign IRS.gov Web site;
- \$247 million to reduce the tax gap. The three largest initiatives associated with this effort are \$121 million for international enforcement to address offshore tax evasion; \$78 million for under-reporting by corporate and high-wealth taxpayers, tax abuse, and other under-reporting issues; and \$38 million to broaden collection coverage;
- \$168 million to complete development of the new taxpayer account database and continue investments in electronic filing systems. This includes continuing development and deployment of BSM projects such as Modernized e-File, core infrastructure (such as portals, hardware, software, and security), and system engineering management capabilities (including project planning and monitoring); and
- \$3 million program reinvestment of a portion of the electronic filing savings to fund the one-time separation costs associated with the September 30, 2011, closure of the Atlanta submission processing site.

Additionally, IRS identified \$9 million in program reductions to the taxpayer advocate service case processing activities, Low-income Taxpayer Clinic grants, Tax Counseling for the Elderly program, and Volunteer Income Tax Assistance grants to realign the programs to the fiscal year 2009 enacted levels.

Maintaining Current Levels

The IRS is requesting about \$86 million to fund nonlabor inflation adjustments and an increase in Federal Employment Retirement System participation. Nonlabor inflation adjustments include rent, postage, supplies, and equipment. No inflation adjustment is requested for pay in fiscal year 2012.

Program Reinvestment

The increased use of electronic filing has led to the consolidation of sites that process paper individual returns. Resources from electronic filing savings will be reinvested to fund one-time separation costs associated with the September 30, 2011, closure of the Atlanta submission processing site. The IRS fiscal year 2012 budget request includes a net increase of \$1.5 million related to this effort.

Efficiencies and Savings

The IRS fiscal year 2012 budget request includes a net reduction of about \$190 million related to efficiency savings. This \$190 million reduction represents a total of 523 FTEs. The four largest areas of cost savings are outlined below.

\$75 Million Decrease From Reduced Information Technology Infrastructure.—The IRS intends to reduce its infrastructure through the use of the Capability Maturity Model (a process improvement approach that yields efficiencies in software engineering); the use of the Information Technology Infrastructure Library, which will allow IRS to improve the quality of its information technology services; and further consolidate its security activities to leverage security best practices.

\$27.3 Million Decrease From Reduced Training, Travel, and Programs.—IRS intends to reduce nontechnical training and noncase-related travel, and plans to implement various program efficiencies. IRS expects to achieve program efficiencies in the BSM, Health Insurance Tax Credit Administration, and various taxpayer com-

munication and education programs. IRS also projects this efficiency initiative will lead to a reduction of 41 FTEs.

\$22.4 Million Decrease From Increased Electronic Filing Savings.—This decrease results from savings from increased electronic filing. Savings are based on projected growth in electronic filing and continued modernization efforts. As a result of this efficiency initiative, IRS projects it would need 416 fewer FTEs in submission processing.

\$22 Million Decrease From Nonrecurring Savings.—These savings would result from the net reduction of nonrecurring, one-time costs associated with various fiscal year 2011 enforcement initiatives (e.g., information technology equipment and training).

Program Increases

The IRS is requesting an increase of about \$839 million for:

- enforcement initiatives;
- infrastructure initiatives; and
- taxpayer service initiatives.

The largest component of the \$839 million increase is \$606 million related to enforcement initiatives. The \$606 million for the enforcement initiatives includes \$243 million for activities IRS believes will yield direct measurable results through an ROI. IRS estimates that the activities funded by the \$243 million increase will generate \$1.3 billion annually in additional enforcement revenues in fiscal year 2014. As stated earlier, many of the initiatives affect more than one appropriation account. Additionally, the \$839 million in fiscal year 2012 program increases are in addition to the increases requested for all five appropriation accounts to reach the fiscal year 2011 budget request.

The fiscal year 2012 budget request does not separately align the various program increases to the tax gap; however, many of the initiatives refer to the tax gap. IRS also states that helping taxpayers understand their obligations under the tax law is critical to improving compliance and addressing the tax gap.

IRS Enforcement Initiatives.—\$606 million increase¹⁰ focuses on activities targeted at improving compliance through nine multi-year initiatives. These activities form the backbone of the IRS's approach to address the tax gap.

The five largest enforcement initiatives are summarized below.

\$260.3 Million To Ensure Accurate Delivery of Tax Credits.—This initiative calls for 834 new FTEs. IRS expects this initiative will improve the delivery of existing credits through a combination of improved technology tools and increased enforcement staffing. The initiative also funds the information technology and other systems required to implement the new ACA's Premium Assistance Tax Credit, which becomes effective in 2014. IRS expects that this initiative will produce additional annual enforcement revenue of \$183.3 million (an ROI of 4 to 1) in fiscal year 2014.

\$96.7 Million To Increase Coverage To Address Tax Law Changes and Other Compliance Issues (Tax Gap).—This initiative calls for 497 new FTEs. IRS anticipates this initiative will address compliance issues and new responsibilities arising from recent tax law changes included in major legislation such as the American Recovery and Reinvestment Act of 2009¹¹ and the ACA. This initiative will fund compliance programs needed for new provisions such as direct-pay bonds, new requirements on tax-exempt hospitals, a new fee on manufacturers and importers of branded prescription drugs, and the excise tax on indoor tanning. It will also increase audits of specialty programs (i.e., employment tax, excise tax, and estate and gift tax). IRS believes this initiative will produce additional annual enforcement revenue of \$80.8 million (an ROI of 3 to 1) in fiscal year 2014.

\$72.6 Million To Increase International Service and Enforcement.—This initiative calls for 377 new FTEs. IRS expects it will be able to implement changes required by enactment of the Hiring Incentives to Restore Employment (HIRE) Act of 2010,¹² with funding for this initiative. IRS will implement the reporting, disclosure, and withholding requirements and expand coverage of international filings; conduct more in-depth international compliance work; strengthen compliance efforts related to offshore activity; and expand the Global High-Wealth Compliance Group. IRS predicts that this initiative will produce additional annual enforcement revenue of \$467.1 million (an ROI of 8 to 1) in fiscal year 2014.

¹⁰ IRS enforcement initiatives are funded from a variety of appropriations. Therefore, the requested \$606 million increase in enforcement initiatives will not equal the requested \$462 million increase in enforcement appropriations identified on page 3.

¹¹ Public Law 111–5, 123 Stat. 115.

¹² Public Law 111–147, 124 Stat. 71.

\$58.5 Million To Administer New Statutory Reporting Requirements.—This initiative calls for 187 new FTEs. Recent legislation established significant new information reporting and sharing requirements from third parties (such as employers and health insurance providers), and the exchanges to administer the ACA's Premium Assistance Tax Credit, the individual coverage requirement, and the employer responsibility payment. Effective implementation requires significant enhancements to existing information returns systems to handle the additional volumes and new information reporting categories. This initiative also includes resources to implement provisions that allow IRS to share tax data with State and Federal entities to determine eligibility for the credit and to ensure the secure exchange of information.

\$52 Million To Increase Collection Coverage.—This initiative calls for 413 new FTEs. IRS expects this initiative will expand work on the collection inventory and improve collection processes to bring taxpayers who fail to pay their debt into compliance and produce additional annual enforcement revenue of \$398.3 million (an ROI of 9 to 1) in fiscal year 2014.

Infrastructure Initiatives.—\$119 million increase focuses on enhancing employee security, developing disaster recovery system capability, and establishing systems to implement various provisions of ACA through four initiatives. The three largest initiatives are summarized below.

\$62.5 Million To Implement Individual Coverage Requirement and Employer Responsibility Payments.—This IRS initiative supports the development of information technology, infrastructure, and systems to implement the provisions of ACA that establish shared responsibility payments for both individuals and employers. IRS requested an additional 65 FTEs for this program initiative. Beginning in 2014, the ACA requires individuals who are able to afford health insurance to obtain minimum essential coverage or pay a penalty. If affordable coverage is not available, certain individuals may be eligible for an exemption.

\$27.5 Million To Update the Integrated Financial System (IFS).—IRS believes updating the IFS will ensure compliance with future Federal accounting requirements; eliminate current work-around processes necessary to support adjustments and reimbursable receivables activities not provided in the current system; eliminate the year-end blackout period and multiple budget versions; and eliminate the month-end accrual process because liabilities would post upon receipt. This initiative calls for five new FTEs.

\$15.5 Million To Enhance Physical Security for Federal Employees.—The February 2010 attack against the Austin, Texas, IRS office killed one IRS employee and injured several others. As a result of this attack, this initiative will provide the investments needed to update and/or upgrade the physical security of IRS facilities. The investments are designed to enhance the overall security of IRS employees in the workplace. This initiative calls for 10 new FTEs.

Taxpayer Services Initiatives.—\$114 million increase focuses on improving taxpayer service and the IRS.gov Web site through two initiatives as summarized below.

\$81.3 Million To Improve Taxpayer Service.—IRS expects this initiative and the \$25.9 million increase requested for fiscal year 2011 will provide additional staffing of at least 519 FTEs to address rising demand and increase the customer service representative level of service from the planned target of 71 percent in fiscal year 2010 to 80 percent in fiscal year 2012, while maintaining a 93 percent customer satisfaction rate for toll-free telephone services. This initiative also includes funding to help taxpayers understand the new tax law provisions and to make related call center and infrastructure changes to handle anticipated inquiries, including questions regarding the ACA.

\$33 Million To Expand Online Options Through IRS.gov Improvements.—This IRS initiative will continue the multi-year effort to replace the outdated web portal environment and provide additional online services to taxpayers. This initiative will allow the IRS to continue the replacement of an outdated web portal environment that has reached the end of its useful life with the help of 15 additional FTEs.

Chairman Durbin, Ranking Member Moran, and members of the subcommittee, I thank you for the opportunity to provide this statement regarding the fiscal year 2012 budget request for IRS.

PREPARED STATEMENT OF NINA E. OLSON, NATIONAL TAXPAYER ADVOCATE,
INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY

Chairman Durbin, Ranking Member Moran, and distinguished members of this subcommittee: Thank you for inviting me to submit this written statement regard-

ing the proposed budget of the Internal Revenue Service (IRS) for fiscal year 2012.¹ As the National Taxpayer Advocate, the statutory voice for taxpayers and taxpayer rights inside IRS, I submit the following thoughts for your consideration:

- IRS requires additional funding to collect the revenue that supports the Federal Government and to better meet the service needs of the taxpaying public.
- IRS, in particular, requires more funding to improve taxpayer services. Both the quality of taxpayer services, like answering taxpayer phone calls and responding to correspondence, and the quantity of taxpayer outreach and education have diminished in recent years. At this point, only 5 percent of the IRS budget is allocated for pre-filing taxpayer assistance and education. In addition, the combination of increased IRS enforcement actions and the recession has created substantially greater taxpayer need for assistance from the Taxpayer Advocate Service (TAS) and the Low Income Taxpayer Clinic program.
- The existing IRS budget structure does not accurately portray the activities of IRS. In particular, a significant percentage, and perhaps the majority, of funding included in the “taxpayer services” account is not spent on programs commonly viewed as taxpayer service.
- The “program integrity allocation adjustment” mechanism has been used in a manner that enables the IRS to receive extra funding for enforcement but not for its taxpayer service activities. Under the proposed fiscal year 2012 budget, IRS would receive an additional \$936 million in enforcement funding through this mechanism (which amounts to 16 percent of the \$5,966,619,000 enforcement total), while receiving \$0 in additional taxpayer-service funding through this mechanism.² This is true despite the fact that taxpayer service indisputably plays a significant role in promoting tax compliance.
- IRS desperately needs to conduct or commission better research so it can allocate its service and enforcement resources more efficiently.
- IRS should revise its mission statement to acknowledge explicitly that its traditional role as the tax collector has expanded in recent years so that it is now both:
 - collecting taxes; and
 - administering social and economic benefits programs.

This dual role should also be recognized explicitly in the budget to ensure the IRS receives sufficient funding to staff and perform both roles effectively.

Before I delve into these issues, I want to take a moment to acknowledge the extraordinary work of the IRS workforce and its leadership. In fiscal year 2010, IRS collected more than \$2.3 trillion to support the financial commitments of the Federal Government.³ It processed about 2.7 billion information returns⁴ and about 230 million tax returns, including 141 million individual returns, 7 million corporation returns, and 30 million employment tax returns.⁵ Customer service representatives answered 47 million calls,⁶ and IRS enforcement personnel ramped up examination and collection activities.⁷ At the same time, IRS launched major initiatives to regulate Federal tax return preparers and combat noncompliance by taxpayers utilizing offshore bank accounts. There are always tasks IRS could perform better—and I will address some of them below—but I think it is important to place these comments in context by acknowledging how much the IRS does very well.

¹The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of the Internal Revenue Service (IRS). However, the National Taxpayer Advocate presents an independent taxpayer perspective that does not necessarily reflect the position of IRS, the Treasury Department, or the Office of Management and Budget. Congressional testimony requested from the National Taxpayer Advocate is not submitted to IRS, the Treasury Department, or the Office of Management and Budget for prior approval. However, we have provided courtesy copies of this statement to both IRS and the Treasury Department in advance of this hearing.

²IRS FY 2012 Budget Request, *Congressional Budget Submission 77* (Feb. 14, 2011), available at http://www.treasury.gov/about/budget-performance/Documents/CJ_FY2012_IRS_508.pdf.

³IRS Data Book, FY 2010, Table 1.

⁴*Id.* at Table 14.

⁵*Id.* at Table 2.

⁶IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (week ending September 30, 2010).

⁷See IRS FY 2010 Enforcement Results, available at http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf.

IRS REQUIRES ADDITIONAL FUNDING TO MAXIMIZE THE COLLECTION OF TAX REVENUE
AND TO BETTER MEET THE SERVICE NEEDS OF THE TAXPAYING PUBLIC

As I have testified previously, I view IRS as the accounts receivable department of the Federal Government. If the Federal Government were a private company, its management would fund the accounts receivable department at whatever level it believed would maximize the company's bottom line. Since the IRS is not a private company, maximizing the bottom line is not—in and of itself—an appropriate goal. But the public sector analogue should be to maximize tax compliance, especially voluntary compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden. Studies show that if IRS were given more resources, it could collect substantially more revenue.

In my 2006 Annual Report to Congress, I recommended that the Congress provide IRS with after-inflation increases of about 2 percent to 3 percent a year for the foreseeable future. I continue to believe that increasing IRS budget at this rate is an excellent financial investment.

Most Federal expenditure programs are just that—expenditure programs. The funds are intended to be spent on worthwhile programs, but the expenditures generally do not directly generate more Federal revenue. IRS is different. IRS collects well more than 90 percent of all Federal revenue.⁸ On a budget of about \$12.1 billion,⁹ IRS collected about \$2.35 trillion in fiscal year 2010.¹⁰ In other words, every \$1 appropriated for the IRS produced about \$194 in Federal revenue.

In evaluating the likely revenue benefits of additional funding, the average return on investment (ROI) of 194:1 is less important than the marginal ROI that can be achieved for each additional \$1 spent. While the marginal ROI is considerably less than 194:1 and will differ by program, studies generally show that, within reasonable limits, each additional \$1 appropriated to IRS generates substantially more than an additional \$1 in Federal revenue, assuming the funding is wisely spent. (As I discuss below, however, IRS needs to develop improved methods to measure the ROI of its activities.)

Because of our national fiscal challenges, there has been considerable discussion recently about freezing or reducing all domestic discretionary spending. In my view, IRS as the tax collector should be exempt from any such freeze or reduction. Reducing funding for IRS will almost surely increase the deficit, because the reduction in revenue collected by the IRS will exceed the reduction in funding. A decision by the Congress to address our budget problem by cutting IRS funding would be akin to a private business attempting to address a spending shortfall by cutting its accounts receivable department. In other words, it would be penny-wise, but pound-foolish.

Recommendation

In light of IRS' unique role as the Federal revenue collector, I recommend that the Congress develop new budget procedures to ensure that IRS is funded at whatever level will maximize tax compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden. Over the long term, this approach may include exempting IRS from spending ceilings or even taking IRS off-budget. In the short run, this approach should include carving out IRS from discretionary budget freezes intended to reduce the deficit, as cuts to IRS budget are likely to increase the deficit.

IRS ESPECIALLY REQUIRES MORE FUNDING TO IMPROVE TAXPAYER SERVICES

IRS' fiscal year 2005–fiscal year 2009 strategic plan was based on the slogan, “Service + Enforcement = Compliance”, and IRS in fiscal year 2006 proposed to restructure its budget so that the two principal categories would be “taxpayer services” and “enforcement”. In both cases, service is listed before enforcement. Although we view this formula as simplistic,¹¹ it reflects the indisputable premise that both

⁸ See IRS Fact Sheet, FS–2011–09, *IRS FY 2012 Budget Proposal Summary* (February 2011), available at <http://www.irs.gov/newsroom/article/0,,id=235959,00.html>.

⁹ Department of the Treasury, *FY 2012 Budget in Brief* (showing fiscal year 2010 enacted levels).

¹⁰ Government Accountability Office, GAO–11–142, *Financial Audit: IRS's Fiscal Years 2010 and 2009 Financial Statements* at 59 (November 2010).

¹¹ See, e.g., *Internal Revenue Service FY 2008 Budget Request: Hearing Before the Subcomm. on Financial Services and General Government of the S. Comm. on Appropriations*, 110th Congress (2007) (statement of Nina E. Olson, National Taxpayer Advocate); *Internal Revenue Service FY 2006 Budget Request: Hearing Before the Subcomm. on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies of the S. Comm. on Appropriations*, 109th Congress (2005) (statement of Nina E. Olson, National Taxpayer Advocate).

taxpayer service and enforcement contribute to tax compliance. Despite the intended implication that there is some rough equivalence between taxpayer service and enforcement in bringing about tax compliance, however, there is no equivalence in the IRS budget.

For fiscal year 2012, the proposed budget would spend \$701 million on “Pre-filing Taxpayer Assistance and Education”, which is what most taxpayers think of as taxpayer service. This amounts to only 5 percent of the IRS budget. The last few years have been particularly challenging for IRS and many taxpayers, as the recently enacted Economic Stimulus Payments, First-Time Homebuyer Credits, and Making Work Pay Credits, among other tax benefits, have proven complex to claim or substantiate and have led to a significant increase in taxpayer inquiries and problems. As I will describe below, IRS has been unable to keep up with taxpayer needs.

Significantly, IRS has been ramping up spending for enforcement programs in recent years while holding taxpayer-service spending flat. If the proposed fiscal year 2012 budget is adopted without change, spending for the enforcement account will have increased by 15.4 percent while spending for the taxpayer services account will have declined by 0.3 percent since fiscal year 2006 on an inflation-adjusted basis.¹²

Not surprisingly, key IRS performance measures have improved for enforcement, but declined for taxpayer service. For example, IRS’ fiscal year 2010 Management Discussion and Analysis included in the GAO’s financial audit of the IRS states: “Collection related to enforcement activities totaled \$57.6 billion, a 34 percent increase over fiscal year 2004.”¹³ By contrast, I note that IRS answered 74 percent of all calls from taxpayers seeking to speak with a telephone assister in fiscal year 2010 as compared with 87 percent in fiscal year 2004, a decline of 13 percentage points, or 15 percent.¹⁴ IRS’ ability to timely process taxpayer correspondence has also declined. Comparing the final week of fiscal year 2004 with the final week of fiscal year 2010, the backlog of taxpayer correspondence in the tax adjustments inventory has jumped by 76 percent (from 357,151 to 628,016), the percentage of “uncontrolled” correspondence received, but not yet entered into IRS computer systems has increased by 134 percent (from 8.3 percent to 19.4 percent of correspondence), and the percentage of taxpayer correspondence classified as “overage” has increased by 135 percent (from 11.5 percent to 27 percent).¹⁵

Taxpayer Service Contributes to Higher Rates of Tax Compliance, and Outreach and Education in Particular Should be Increased

Despite general agreement that both service and enforcement contribute to greater tax compliance, policymakers seeking to improve compliance and close the tax gap tend to focus almost exclusively on new enforcement measures—more audits, more collection actions, and more third-party information reporting to facilitate data-matching. The central role that service plays in promoting tax compliance is all too often overlooked.

At the most basic level, there would be no compliance if IRS did not publish forms and publications, provide instructions on how to file returns, and answer filing-related questions. However, taxpayer service goes beyond merely publishing forms and answering telephone calls.

Taxpayer outreach and education are critically important to achieving voluntary tax compliance, which is the cheapest type of compliance for the government. In my view, IRS is not conducting nearly enough outreach and education to taxpayers, especially self-employed and small business taxpayers, to maximize voluntary compliance. According to IRS’ most recent estimate of unpaid taxes, \$148 billion, or 43 percent of the aggregate tax gap, is attributable to unreported income earned by unincorporated businesses and the associated unpaid self-employment tax.¹⁶

To be sure, a portion of the small business tax gap reflects a willful failure to report income. However, another portion reflects lack of knowledge about how to com-

¹² Compare Department of the Treasury, *FY 2012 Budget-in-Brief with Department of the Treasury, FY 2008 Budget-in-Brief*. (The fiscal year 2006 budget was adopted using a different budget structure. The proposed fiscal year 2008 budget shows the enacted fiscal year 2006 totals as translated into the current budget structure.) Inflation adjustments were made using the Bureau of Labor Statistics inflation calculator, available at <http://data.bls.gov/cgi-bin/cpicalc.pl>.

¹³ Government Accountability Office, GAO-11-142, *Financial Audit: IRS’s Fiscal Years 2010 and 2009 Financial Statements* at 23 (November 2010).

¹⁴ See *IRS FY 2010 Enforcement Results*, available at http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf.

¹⁵ Compare IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending September 25, 2010) with IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending September 25, 2004).

¹⁶ See IRS News Release, IR-2006-28, *IRS Updates Tax Gap Estimates* (February 14, 2006) (accompanying slide 1), available at <http://www.irs.gov/newsroom/article/0,,id=154496,00.html>.

ply. For example, consider an individual without a college degree who becomes a successful plumber or electrician with a growing customer base. If he hires employees, he will face a host of employment, immigration verification, and local, State and Federal tax requirements, including the need to withhold and pay over payroll taxes with respect to his employees and to file employment tax and income tax returns on behalf of his business. Moreover, he likely will need to grapple with complex rules such as those dealing with automobile and transportation expenses, inventory, and depreciation of equipment and other fixed assets. For most taxpayers, these requirements would seem daunting or even impenetrable, and some taxpayers inevitably do not comply simply because they have no idea where to begin.

IRS' current compliance strategy, which consists largely of posting general information on its Web site and auditing a tiny fraction of small business returns,¹⁷ can be improved. IRS can increase compliance in the small business community efficiently if it expands its outreach and education efforts through a more robust field function and commits more resources to meeting proactively with small businesses that are starting operations.

In fiscal year 2006, the Appropriations Committees of the House and the Senate directed IRS, the IRS Oversight Board, and the National Taxpayer Advocate to collaboratively develop a 5-year strategic plan for taxpayer service.¹⁸ In response, the IRS developed a plan known as Taxpayer Assistance Blueprint (TAB). IRS conducted extensive research on the needs and preferences of individual taxpayers in the course of developing TAB. Pursuant to annual appropriations directives, IRS is continuing to provide the Appropriations Committees with annual progress reports.

As I have recommended before—and as the Appropriations Committees urged 2 years ago¹⁹—IRS should expand the scope of its TAB research studies to include self-employed and small business taxpayers and then should apply the knowledge it acquires through the studies to all of its interactions with those taxpayers. IRS should also expand its outreach to tax-exempt organizations to improve compliance in that sector.

Taxpayer Services Should Be Strengthened To Meet the Service Needs of U.S. Taxpayers.

Beyond compliance, I believe IRS has an obligation to provide high-quality service to its taxpayers simply as a matter of good government. When we ask people to pay over a large percentage of their income to the Government each year, the least we can do is make the process as simple and painless as possible.

In important respects, IRS taxpayer service is falling short. Consider the following four examples:

Telephone Service.—Each year, tens of millions of taxpayers call the IRS seeking help with a wide variety of issues, including account questions and tax-filing questions. Yet IRS is unable to answer a large percentage of these telephone calls. The Customer Account Services (CAS) Customer Service Representative Level of Service (LOS), generally measures the percentage of calls that get through to a representative among all callers seeking to do so. By this measure, as noted, IRS answered 87 percent of its calls in fiscal year 2004. Since that time, LOS has been declining, plummeting to a low of 53 percent in fiscal year 2008. In other words, IRS telephone assistants in fiscal year 2008 were unable to answer nearly one-half of the calls they received.

In fiscal year 2010, LOS rebounded somewhat to about 74 percent, and it is running at about that level so far in fiscal year 2011.²⁰

While answering 74 percent of calls is a vast improvement over 53 percent, it means IRS is still failing to answer 1 out of every 4 calls it receives from taxpayers who need assistance. Equally concerning, among calls that do get an-

¹⁷In fiscal year 2010, IRS audited 0.58 percent of all business returns, including 0.94 percent of small C corporations (under \$10 million in assets), 0.37 percent of Subchapter S returns, and 0.36 percent of partnership returns. See *IRS Fiscal Year 2010 Enforcement Results*, available at http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf.

¹⁸House Report 109–307, at 209 (2005) (Conference Report).

¹⁹The House report “urge[d] the IRS to continue to expand upon its TAB-related work with regard to small business and self-employed taxpayers and tax-exempt and government entities, and to include these additional categories in the annual IRS update to the TAB.” House Report 111–202, at 21–22 (2009). The Joint Explanatory Statement of Managers accompanying the conference report made clear that the House language was approved by the conference committee. House Report 111–366, at 892 (2009) (Conference Report).

²⁰See *IRS FY 2010 Enforcement Results*, available at http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf; IRS, Joint Operations Center, *Snapshot Reports: Customer Account Services—CAS* (week ending May 21, 2011).

swered, the average wait time in fiscal year 2010 was nearly 11 minutes,²¹ up from about 4½ minutes in fiscal year 2007.²²

Although hard to quantify, the impact of IRS' inability to answer taxpayer calls is significant and has considerable downstream consequences:

- When taxpayers call the toll-free line with tax law questions and cannot get through, some will just give up and not bother to file their tax returns. Others will file inaccurate returns that require IRS follow-up action and taxpayer response.
- When taxpayers receive notices proposing additional tax, many have questions and try to reach IRS by phone. If they cannot get through, they remain unsure about what to do and some will not respond, requiring IRS to take further steps and potentially exposing those taxpayers to enforced collection action. Others will write letters to IRS, requiring IRS employees in the AM function to respond.

In his book, "Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America", former Commissioner Charles Rossotti addressed the importance of maintaining a high level of service on IRS' toll-free lines:

"Apart from the justifiable outrage it causes among honest taxpayers, I have never understood why anyone would think it is good business to fail to answer a phone call from someone who owed you money."²³

Let me be clear that I am not being critical of IRS' handling of the increased telephone volume—it generally is applying its current resources appropriately and is seeking new ways to use those resources more productively. However, to meet taxpayers' needs, to improve taxpayers' ability to comply with the law and respond to IRS notices, and to reduce the aggregate burden on IRS when those who cannot get through by phone contact IRS through multiple channels with the same question, I believe IRS must be able to answer at least 85 percent of taxpayer calls and keep taxpayers on hold for no longer than an average of 5 minutes.²⁴

Taxpayer Correspondence.—IRS' responsiveness to taxpayer correspondence is also lagging. Some AM employees shuttle back and forth between working with paper correspondence (including the processing of amended returns) and answering telephone calls. When IRS employees dedicated exclusively to answering taxpayer calls cannot handle the volumes, AM employees are shifted from handling paper correspondence to help out. Not surprisingly, as call volumes have increased and AM employees have been moved to answer telephone calls, paper correspondence inventories have increased as well. The correspondence inventory rose from approximately 480,000 at the end of fiscal year 2007 to approximately 628,000 at the end of fiscal year 2010—a 31 percent increase.²⁵

To some degree, the combination of poor telephone service and slow correspondence processing creates a vicious cycle: Taxpayers who cannot get through to IRS by telephone send letters, causing more work for employees assigned to paper correspondence and leading to correspondence backlogs and delays in processing amended returns, while taxpayers who write to IRS and do not receive timely responses call IRS to try to figure out what happened. IRS requires taxpayers to file their returns and respond to notices on a timely basis. Taxpayers have a right to expect comparable timeliness of the IRS.

TAS.—The workload facing my own organization, the TAS, has increased substantially in recent years. Although TAS has other important responsibilities, we are primarily the case-working operation of IRS for taxpayers who are experiencing a significant hardship. We assist taxpayers who are experiencing a current or imminent financial hardship as a result of an IRS action or inaction (e.g., where an IRS levy against a taxpayer's paycheck will lead to eviction or a shutoff of utilities) or who are experiencing a systemic hardship because IRS has not served them on a timely or accurate basis (e.g., where IRS has failed to issue a refund or process a taxpayer's response to an audit or collection notice). By statute, the Congress has required that TAS make at least one advo-

²¹ IRS, Joint Operations Center, *Snapshot Reports: Customer Account Services—CAS* (week ending September 30, 2010).

²² IRS, Joint Operations Center, *Snapshot Reports: Customer Account Services—CAS* (week ending September 30, 2007).

²³ Charles O. Rossotti, *Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America* 285 (2005).

²⁴ For a more detailed discussion of IRS' toll-free telephone service, see National Taxpayer Advocate 2009 Annual Report to Congress 4–16 (Most Serious Problem: *IRS Toll-Free Telephone Service Is Declining as Taxpayer Demand for Telephone Service Is Increasing*).

²⁵ IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (weeks ending September 29, 2007 and September 25, 2010, respectively).

cate available for each State,²⁶ and we currently have 74 offices that serve taxpayers. Many of you are familiar with our local taxpayer advocates, because TAS handles congressionally referred taxpayer cases as well.

TAS's annual case receipts rose from 168,856 in fiscal year 2004 to 298,933 in fiscal year 2010—an increase of 77 percent. For the first half of fiscal year 2011, TAS case receipts have risen by an additional 4.3 percent as compared with the first half of fiscal year 2010. There are two main drivers of this increase. First, the majority of TAS' cases stems from IRS compliance actions, and IRS has substantially increased the number of these actions in recent years.²⁷ Second, TAS receives more cases during economic downturns, when more taxpayers cannot pay their tax bills and get into trouble with IRS.

To date, TAS has managed to handle the increased caseload. After several years of declining staffing, the TAS has been able to hire three new categories of employees over the past few years to assist our case advocates in doing their jobs. We now have 116 “intake advocates”, who answer telephone calls, respond to simple taxpayer questions, and assist with case-building by identifying key facts and issues and requesting necessary documentation. We also have 127 “lead case advocates”, who mentor and assist case advocates with unusually challenging cases, maintain partial caseloads of their own, and help develop the TAS best practices. Finally, we have 18 “campus technical advisors”, who provide technical guidance and support on complex cases worked by IRS in each of its 10 campuses. These additional specialty positions have freed up our case advocates to spend more direct time resolving taxpayer cases and have given them helpful resources when they get stuck on technical issues. The TAS management has also taken steps to improve efficiencies.²⁸

As a result of these measures, I am pleased to report that the TAS has continued to perform well. In fiscal year 2010, the TAS obtained full relief for taxpayers in 69 percent of our cases and partial relief for taxpayers in an additional 5 percent. (In other cases, taxpayers generally are not entitled to relief.) These levels are consistent with historical norms. In addition, ongoing surveys conducted by an independent polling firm among taxpayers assisted by the TAS show that customer satisfaction stood at 84 percent in fiscal year 2004 and at 85 percent in fiscal year 2010.

Despite these positive results, the significant increase in case inventories is beginning to strain TAS' capacity. In fiscal year 2004, TAS case advocates annually handled an average of 135 cases, and their caseloads have been steadily increasing since that time. In fiscal year 2010, the average annual caseload per advocate rose to 240 cases, and in fiscal year 2011, it is projected to reach 249 cases.²⁹

Because cases generally come to TAS only when a taxpayer is suffering from a financial hardship or the IRS' regular processes have not worked as they should, the TAS as a practical matter is often a taxpayer's last resort. As the IRS' “safety net” for taxpayers, TAS has had a policy of assisting all taxpayers who meet our case-acceptance criteria since the Congress created our organization in 1998. If the imbalance between our resources and the demand for our services widens much further, however, we will have no choice but to decline to accept certain categories of cases, leaving taxpayers to fend for themselves. I have served as the National Taxpayer Advocate for 10 years, and this is the first time I have felt compelled to sound this alarm. But I am deeply concerned that if TAS is subject to spending freezes and does not have adequate resources,

²⁶ IRC § 7803(c)(2)(D)(i)(I).

²⁷ From fiscal year 2004 to fiscal year 2010, levies rose from 2,029,613 to 3,606,818; liens rose from 534,392 to 1,096,376; and seizures rose from 440 to 605. See *IRS FY 2010 Enforcement Results*, available at http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf.

²⁸ One important current project is the development and deployment of a new, fully integrated system for TAS, which will automate many manual operations and integrate case advocacy, systemic advocacy, and all other TAS activities. This system, known as the Taxpayer Advocate Service Integrated System (TASIS), will replace more than 10 stand-alone systems and databases and improve efficiency by enabling employees to work across IRS systems, maintain and search case files electronically, and handle the intake, screening, and distribution of work electronically. TASIS will also enable management to ensure a more even distribution of workload because it will provide information not merely on the number of cases per case advocate, but also on case complexity, required skills, and anticipated time required for case completion. Assuming the funding committed to the project is not cut or deferred, we anticipate that much of TASIS will be operational in 2013.

²⁹ Average annual caseloads represent aggregate TAS case receipts divided by the sum of case advocates, intake advocates, and half of TAS's lead case advocates. (lead case advocates spend approximately 50 percent of their time on non-case-specific work, including training and non-evaluative reviews).

we will be forced to turn away cases and taxpayers will suffer significant hardships as a consequence.

Low-income Taxpayer Clinics (LITCs).—In 1998, the Congress established a grant program to fund LITCs.³⁰ LITCs primarily represent low-income taxpayers in Federal tax controversies with IRS for free or for a nominal charge.³¹ For fiscal year 2010, the Congress provided \$10 million for LITCs.

Largely because of the recession and consequent job losses, LITC case inventories have risen substantially. LITCs collectively worked 16,374 cases in 2008 and 21,801 cases in 2009, an increase of 33 percent. During the first 6 months of 2010, LITCs worked 17,293 cases—more than the number they handled during all of 2008. Low-income taxpayers who face IRS audits or collection action have few alternative options for assistance. With roughly a doubling of cases in the last 2 years, it is critical that LITCs receive sufficient resources to deal with these caseloads.

In its fiscal year 2011 budget recommendation, the IRS Oversight Board recommended a \$2.3 million initiative to expand coverage of the LITC program. The Oversight Board noted:

“The current economic environment presents significant challenges as the number of taxpayers who cannot pay their liabilities is increasing while available assistance from tax professionals is declining.

“Taxpayers who want to comply with their tax obligations and responsibilities must have access to information, assistance, and, when appropriate, representation. Low-income taxpayers who cannot afford representation can be at a disadvantage in resolving tax disputes with the IRS. For example, a recent TAS research study found that taxpayers who were represented in Earned Income Tax Credit (EITC) audits by attorneys, accountants, enrolled agents, or even unenrolled return preparers, were nearly twice as likely to receive the EITC, and received almost twice as much EITC, as taxpayers who were unrepresented. Thus, LITCs ensure that low-income taxpayers receive the correct outcome in controversies with the IRS and pay the correct tax amount.”³²

The administration’s proposed fiscal year 2012 budget would reduce funding for LITCs by \$500,000. I believe the LITCs need additional funding to provide assistance to low-income taxpayers whom IRS has targeted for enforcement action.

Recommendations

Both to improve tax compliance and to meet the needs of the taxpaying public, I recommend that the Congress provide additional funding for taxpayer-service activities, including increased funding for LITCs.

To enable the IRS to better meet the needs of small business taxpayers and tax-exempt organizations, I recommend that the Congress direct the IRS to conduct comprehensive TAB-like research studies of those populations.

IRS BUDGET STRUCTURE DOES NOT ACCURATELY PORTRAY THE IRS’ ACTIVITIES AND PROBABLY OVERSTATES SPENDING FOR TAXPAYER SERVICE

As discussed above, IRS since fiscal year 2006, has been proposing its budget by classifying most activities as either “taxpayer services” or “enforcement”. For a number of reasons, including the availability of program integrity allocation adjustments for enforcement initiatives (discussed below) and how IRS approaches a program, the classification of an activity as taxpayer service or enforcement has consequences.

One threshold challenge in dividing the budget in this way is that there is no universal agreement on where to draw the line between service and enforcement. For the most part, I think people view “taxpayer service” as including IRS activities that assist them in voluntarily complying with their tax obligations. I think most people view enforcement as including activities IRS undertakes to collect tax liabilities that have not been fully and timely paid.

The current budget follows what I view as a fairly arbitrary division of IRS’ activities into the taxpayer services and enforcement buckets. A few examples will illustrate:

Processing Tax Returns.—The budget treats the processing of tax returns entirely as a taxpayer service. In a response included in the National Taxpayer

³⁰ See IRC § 7526.

³¹ Some LITCs provide tax education and outreach for taxpayers who speak English as a second language.

³² IRS Oversight Board, *FY 2011 IRS Budget Recommendation* 23–24 (March 2010).

Advocate's 2010 Annual Report to Congress, IRS wrote: "The millions of taxpayers who each year voluntarily file and pay their taxes likely would not view the processing of their refunds as anything other than a service activity."³³ The thinking behind this statement is not self-evident. It is true, as IRS has pointed out, that refunds are issued to many taxpayers in the course of returns processing, and it is understandable that taxpayers receiving a refund may see that activity as a service.

It is also true, however, that taxpayers filing returns with balances due are required to remit payment with their returns and that IRS uses the information provided on all tax returns to help it determine which taxpayers to audit. As I observed only somewhat facetiously in my report, if collecting tax payments and facilitating audit selection are the types of services the IRS provides, I believe most taxpayers would choose to take a pass. In my view, returns processing is best classified as neither service nor enforcement. It is simply an overhead or support function that enables the IRS to collect taxes.

AM.—Funding for the AM program, which includes the toll-free phone lines and correspondence processing, is included in the taxpayer services account, even though most of the AM budget is allocated toward working with taxpayers by phone or letter after IRS has proposed a tax adjustment. If IRS generates a notice telling a taxpayer he or she has under-reported income and owes additional tax, it is far from clear that the follow-up costs should be viewed as a "service" rather than "enforcement".

Field Assistance.—Funding for the Field Assistance Program, which includes IRS walk-in sites, is also included in the taxpayer services account. As with AM, more than half the work performed in the walk-in sites relates to account and notice work, so the decision to classify these activities as services is questionable.

Small Business/Self-employed Operating Division.—The Small Business/Self-Employed Operating Division (SB/SE) is tasked with serving all small businesses and self-employed taxpayers. For reasons I have described above, outreach and education are particularly important for this population. First-time business owners face a daunting array of employment tax requirements in addition to recordkeeping and other business income tax requirements. Growing businesses may not recognize tax issues that arise as they become more successful. Businesses experiencing financial difficulties may not understand that ignoring tax issues can further impair their economic viability in the short and long terms. Yet SB/SE is funded almost exclusively from the enforcement account. Only 1 percent of its funding comes from the taxpayer services account.³⁴

TAS and Appeals.—Under the current budget structure, the TAS is funded entirely under the taxpayer services account, while the Office of Appeals is funded entirely under the enforcement account. I am discussing TAS and appeals together because they share similar characteristics. Neither function initiates contact with taxpayers. Rather, both functions become involved in a case when a taxpayer is dissatisfied with actions another IRS function has taken and seeks us out for assistance. This similarity raises questions about the underlying rationale for the difference in budget classification.

There are other reasons to question the distinction as well. Most important, sound accounting principles generally require that revenues be matched with the expenses that generate them. If IRS enforcement functions propose and collect additional tax amounts, downstream costs associated with the revenue IRS receives arguably should be treated as part of the costs of enforcement. If IRS treats revenue generated by the collection function as "enforcement" revenue, but apportions the costs of working with the affected taxpayers to the taxpayer services account—as it currently does by treating TAS as a service expense—the net amount of IRS enforcement revenue will be overstated, perhaps considerably so. This will result in an inflated return on investment (ROI) on enforcement spending and has the potential to distort funding decisions.

In addition, the Office of Appeals is constantly seeking to reassure skeptical taxpayers and practitioners that, despite its placement within IRS, it is independent from the IRS examination and collection functions and will provide taxpayers with an impartial hearing. The decision to fund Appeals entirely from the enforcement account along with the examination and collection functions

³³ National Taxpayer Advocate 2010 Annual Report to Congress 65–66 (*Most Serious Problem: The Wage & Investment Division Is Tasked With Supporting Multiple Agency-Wide Operations, Impeding Its Ability to Serve Its Core Base of Individual Taxpayers Effectively*).

³⁴ IRS, Integrated Financial System, *Status of Available Funds Report* (FY 2010).

may undermine appeals' effort to persuade outsiders that it is not simply another IRS enforcement function.

With respect to the foregoing examples, there is no objectively "correct" answer, so the existing budget categories are not necessarily wrong. But neither are they necessarily right, and that is the source of my concern. Using the terms "taxpayer services" and "enforcement" implies a bright-line distinction that cannot accurately be drawn. In that sense, the labels are arbitrary and somewhat misleading. In addition, because of the significant number of programs placed within the taxpayer services account that do not clearly belong there, I believe the budget may substantially overstate the amount of funding provided for programs that a layman would consider to be taxpayer services. This is significant as a matter of truth in packaging because it may paint an exaggerated portrait of how much emphasis IRS places on taxpayer service activities. As discussed below, it is also significant because programs assigned to the enforcement account may have more funding flexibility due to the operation of program integrity allocation adjustments.

Recommendations

I recommend the following steps:

- Move the funding associated with returns processing into the operations support account.
- Divide the funding associated with AM and field assistance activities between the taxpayer services account and the enforcement account based on the underlying activities to which they relate.
- Divide funding for TAS between the taxpayer services account and the enforcement account based on the percentage of TAS cases that are service-related and the percentage of TAS cases that are enforcement-related.
- Consider for the longer term devising a set of budget categories that do away with the artificial distinction between taxpayer service and enforcement.

THE "PROGRAM INTEGRITY ALLOCATION ADJUSTMENT" MECHANISM HAS BEEN USED IN A MANNER THAT ENABLES IRS TO RECEIVE EXTRA FUNDING FOR ITS ENFORCEMENT ACTIVITIES BUT NOT FOR ITS TAXPAYER SERVICE ACTIVITIES, DESPITE THE FACT THAT TAXPAYER SERVICE ACTIVITIES ALSO CONTRIBUTE TO COMPLIANCE

During the last few years, the IRS budget has utilized a mechanism that makes it relatively easy to provide increases for enforcement spending, but the procedure is not used for the taxpayer services account. Under this mechanism, known as a "program integrity allocation adjustment," new funding appropriated for IRS enforcement programs generally does not count against otherwise applicable spending ceilings provided:

- the IRS's existing enforcement base is fully funded; and
- a determination is made that the proposed additional expenditures will generate a ROI of greater than 1:1 (i.e., the additional expenditures will reduce the deficit on a net basis).

These conditions reflect the fact that IRS is able to project the direct ROI of its enforcement activities—it can measure to the dollar the amounts collected by its examination, collection, and document-matching functions—but faces a much harder task in measuring the ROI of taxpayer services. As discussed above, it seems intuitively clear that the ROI of taxpayer service activities is greater than 1:1. Basic services like publishing tax forms, providing guidance, and answering taxpayer questions are essential for enabling taxpayers to file returns and enabling the IRS to collect revenue. Yet because the IRS cannot quantify either the overall ROI of taxpayer service spending or the ROI of specific taxpayer service initiatives, taxpayer services spending is not currently considered eligible for program integrity allocation adjustments.

As a consequence, the IRS has been able to request larger increases each year for enforcement than for taxpayer services, and it is increasingly becoming more of an enforcement agency with a relatively smaller focus on taxpayer service. If the proposed fiscal year 2012 budget is adopted without change, as noted above, spending for the enforcement account will have increased by 15.4 percent while spending for the taxpayer services account will have declined by 0.3 percent since fiscal year 2006 on an inflation-adjusted basis.³⁵ In essence, the 15.4 percent increase in en-

³⁵ Compare Department of the Treasury, *FY 2012 Budget-in-Brief* with Department of the Treasury, *FY 2008 Budget-in-Brief*. (The fiscal year 2006 budget was adopted using a different budget structure. The proposed fiscal year 2008 budget shows the enacted fiscal year 2006 totals as translated into the current budget structure.) Inflation adjustments were made using the Bureau of Labor Statistics inflation calculator, available at <http://data.bls.gov/cgi-bin/cpicalc.pl>.

forcement is entirely attributable to program integrity allocation adjustments. Under the proposed fiscal year 2012 budget, the IRS would receive an additional \$936 million in enforcement funding through this mechanism, which amounts to 16 percent of the \$5,966,619,000 enforcement total.

Moreover, the recent trend is likely to continue. The administration's fiscal year 2012 budget proposal contains spending projections for future years. Over the next 5 years (from fiscal year 2012 to fiscal year 2016), it projects that enforcement spending will rise by another 28 percent while taxpayer services spending will slightly decline.³⁶

I am deeply concerned about the widening resource gap between the agency's taxpayer service and enforcement programs. First, for reasons discussed in the prior section, I think the distinction between service and enforcement can be highly artificial and arbitrary. To provide substantial additional funding to any program that gets classified as "enforcement" while reducing or holding flat spending for any program that gets classified as "taxpayer service" will not result in a balanced agency and may even encourage game-playing to classify priority programs as enforcement. Moreover, the classification of a program as "enforcement" rather than "service" has significant implications for the way IRS treats taxpayers.

Second, as I have also discussed, it is widely acknowledged that taxpayer service contributes significantly to compliance. In some cases, service may contribute even more than enforcement to improved compliance. Because IRS currently is unable to compute an ROI for service activities, however, service activities by themselves do not qualify for allocation adjustments.

Third, the Congress has given IRS an increasing number of social and economic benefit programs to administer, and as I will discuss below, both of these types of benefits programs typically require more service.

The use of program integrity allocation adjustments has enabled IRS to receive more funding than would otherwise be the case, and I think that is positive. But I strongly encourage IRS and this subcommittee to consider ways to modify the way allocation adjustments are used so that taxpayer needs are met and IRS remains a balanced agency. One possibility is to define new compliance initiatives more broadly, so that they include both an enforcement component and a service component. Because the projected ROI of some types of enforcement initiatives is high, a more broadly constructed initiative could still produce an ROI of greater than 1:1 (i.e., the service components would piggyback on the high-ROI enforcement activity). That could satisfy the requirements for an allocation adjustment while giving the agency more flexibility to meet taxpayer needs and improve compliance in obvious yet currently immeasurable ways.

Example of a Broader Compliance Initiative

Assume the IRS is planning a new enforcement initiative to improve compliance among small business taxpayers. The initiative will cost \$50 million and is projected to produce an ROI of 6:1 (or \$300 million in additional revenue). IRS intends to request \$50 million for this initiative as a program integrity allocation adjustment.

Assume further that IRS has identified taxpayer service activities that would also improve small business compliance, such as new or additional types of outreach and education. The cost of the service initiative would be \$25 million, but IRS cannot quantify the ROI.

If IRS defines new compliance initiatives more broadly to include service activities, it could package the enforcement measures with the outreach and education measures and request \$75 million for the combined initiative as an allocation adjustment. The ROI would still be positive (the \$75 million cost and projected revenue of \$300 million would produce an ROI of 4:1). Most important, IRS would be operating a more integrated, effective, and balanced compliance program.

Recommendation

I recommend that IRS and the Congress consider ways to broaden the use of program integrity allocation adjustments so that compliance initiatives include taxpayer service components.

³⁶*Budget of the United States Government: Analytical Perspectives, Supplemental Materials Fiscal Year 2012: Federal Programs by Agency and Account*, at 317–318, available at http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/33_1.pdf. Taxpayer service spending is shown on page 317 (see line labeled "Taxpayer Services: Appropriations, discretionary . . . 803"). Enforcement spending is the sum of the line on page 317 labeled "(Federal law enforcement activities): Appropriations, discretionary . . . 751" and the line on page 318 labeled "(Central fiscal operations): Appropriations, discretionary . . . 803."

IRS DESPERATELY NEEDS TO CONDUCT OR COMMISSION BETTER RESEARCH SO IT CAN
ALLOCATE ITS SERVICE AND ENFORCEMENT RESOURCES MORE EFFICIENTLY

IRS would be able to allocate its resources more effectively if it had a better understanding of the causes of noncompliance and could test alternative compliance approaches. At present, IRS has a tendency to treat all noncompliance as willful and to treat taxpayers who do not fully comply as “bad” taxpayers.

If all noncompliance reflected a willful decision by taxpayers to cheat the Government, a compliance approach that emphasizes hard-core enforcement measures might make sense. But much, if not most, noncompliance occurs for different reasons. In some cases, taxpayers do not know the rules. In some cases, taxpayers find complying with the rules excessively burdensome or confusing. In other instances, significant life events arise (e.g., illness, unemployment, or divorce) and taxpayers do not file returns. (This cuts both ways from a revenue standpoint. Some taxpayers who owe tax do not file returns, but many taxpayers who are due refunds each year also do not file returns and thus overpay their taxes.) In still other cases, taxpayers are too intimidated to file returns. For example, an individual who loses his job and cannot afford to pay may decide against filing a return because he fears what may happen if he reports a tax liability and cannot pay it.

In large part, IRS’ one-size-fits-all approach reflects the absence of data on which to base better resource-allocation decisions. It bears emphasizing that “direct enforcement revenue” constitutes only about 2 percent of the revenue IRS collects.³⁷ Ninety-eight percent of the revenue IRS collects is paid voluntarily due to a combination of its taxpayer service programs and the indirect, deterrent effect of its enforcement activities. However, IRS does not have adequate data to determine the relative contribution to compliance of taxpayer service and enforcement, let alone which components of taxpayer service and enforcement are most effective. Without these critical pieces of information, resource-allocation decisions are necessarily made more on the basis of best guesses and hunches than empirical evidence.

I suggest that the Congress consider directing IRS to undertake additional research studies, perhaps utilizing the expertise of outside experts, to improve the accuracy of its ROI estimates for various categories of work, especially taxpayer service and the indirect effect of enforcement actions. IRS should also improve its methods of verifying, retrospectively, the marginal ROI it has achieved for each category of work. ROI estimates should include costs relating to the downstream consequences of the various categories of IRS work, including increased phone calls and correspondence, Appeals conferences, TAS cases, and Tax Court litigation.

I acknowledge that developing reasonably accurate modeling is a significant challenge and will require a commitment of resources. Nonetheless, I have recommended in the past and continue to believe that this information will aid IRS enormously in making resource-allocation decisions and will provide Members of Congress with additional information on which to base future funding decisions.³⁸

Recommendation

I recommend that the Congress direct IRS to undertake additional research studies, perhaps utilizing the expertise of outside experts, to improve the accuracy of its ROI estimates for various categories of work, especially taxpayer service and the indirect effect of enforcement actions.

IRS SHOULD REVISE ITS MISSION STATEMENT TO EXPLICITLY ACKNOWLEDGE THAT ITS
TRADITIONAL ROLE AS THE TAX COLLECTOR HAS EXPANDED IN RECENT YEARS SO
THAT IT IS NOW BOTH COLLECTING TAXES AND ADMINISTERING SOCIAL AND ECO-
NOMIC BENEFIT PROGRAMS

Historically, IRS’ mission has been to collect taxes imposed by the Congress to fund Federal spending. In recent years, however, the Congress has increasingly been using the tax code to provide economic incentives or social benefits for taxpayers.

³⁷ In fiscal year 2010, the IRS collected \$2.345 trillion. See *IRS Data Book, FY 2010*, Table 1. The amount of enforcement revenue it collected was \$57.6 billion. See *IRS FY 2010 Enforcement Results*, available at http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf.

³⁸ The congressional budget rules currently prohibit the Congressional Budget Office or the Office of Management and Budget from treating changes in discretionary appropriations to the IRS as giving rise to scorable increases in tax receipts. See House Report 101-964 (1990). See also Office of Management and Budget, *OMB Circular No. A-11*, Part 8, Appendix A, Principle 14 (2006). Because changes to IRS funding levels undoubtedly have an impact on tax collections, this prohibition seemingly reflects the practical difficulty of devising accurate estimates. Yet accurate estimates would be helpful to the Congress, and we believe the IRS should make developing better estimates a priority objective.

In 1975, the Congress enacted the Earned Income Tax Credit, which allows low-income, working taxpayers to receive, through the tax code, Government payments that exceed their income tax liabilities. In 2008, the Congress directed IRS to make Economic Stimulus Payments. Also beginning in 2008, the Congress made available the first of three iterations of the First-Time Homebuyer Credit. Beginning in 2009, the Congress provided the Making Work Pay Credit. Then last year, the Congress enacted the Hiring Incentives to Restore Employment Act, which provides incentives for small businesses to hire additional workers, and the Patient Protection and ACA, which contains numerous provisions that will require interaction between IRS and businesses or individuals.

In many cases, there are compelling reasons for administering these programs through the tax code. Absent adequate planning, however, I am concerned that directing a law enforcement agency to administer such programs could be problematic. While enforcement measures are required to prevent inappropriate claims in benefits programs, the overriding objective of agencies that administer benefits programs has traditionally been to help as many eligible persons qualify for the benefits as possible. That requires extensive outreach and even working one-on-one with potentially eligible individuals.

There are significant differences between benefits agencies and enforcement agencies in terms of culture, mind set, and the skill sets and training of their employees. Benefits agencies like the Social Security Administration and the Department of Veterans Affairs, despite some shortcomings, are primarily trying to get to yes—to help as many eligible persons qualify for benefits as possible. Enforcement agencies are more in the business of saying no. As IRS prepares to administer large portions of the healthcare legislation, including approving claims by low-income persons for healthcare tax credits and imposing a penalty tax on those who are required to purchase health insurance but fail to do so, I believe IRS should hire and train a new category of caseworkers—employees with social welfare-type backgrounds or similar training who will work one-on-one with taxpayers to resolve legitimate disagreements, instead of merely sending out notices saying, in effect, “you owe us.”

In addition, IRS will require more funding to perform effectively both its traditional tax collection role and its expanding role as a benefits administrator. I am convinced that with adequate planning and funding, IRS can do the job. But if IRS does not recognize the importance of improving its benefits administration capacity or does not receive adequate funding, there are likely to be significant violations of taxpayer rights and significant taxpayer burden. In this regard, the trend toward increased funding for IRS’ enforcement account relative to the taxpayer services account, as discussed above, is concerning and should be carefully evaluated.

To help ensure that IRS focuses on these challenges and that its needs are recognized in the budget process, I believe IRS should revise its mission statement to make explicit that its mission is both to collect taxes and to deliver economic and social benefits authorized by the Congress. In this connection, the IRS should:

- revise Revenue Procedure 64–22 to include the IRS’ responsibility as a benefits administrator;
- create a new program office and deputy commissioner position to provide strategic direction for all benefits programs; and
- conduct a comprehensive evaluation of the administration of previous and existing benefits programs to aid in the planning and implementation of future programs.

Recommendation

I recommend that the IRS revise its mission statement to make explicit that its mission is both to collect taxes and to deliver economic and social benefits authorized by the Congress.

CONCLUSION

In this statement, I have attempted to describe six issues that this subcommittee may wish to consider. Some require immediate attention, while others would benefit from consideration over the longer term. In the near term, my overriding concern relates to the overall funding of the IRS. As the Nation’s tax collector, the IRS is part of the solution to the problem of budget deficits, not part of the problem. There has been considerable discussion about freezing all domestic discretionary spending, which would presumably include funding for the IRS. I believe freezing or restricting IRS funding—either for taxpayer service activities or for enforcement activities—would be a mistake and would undermine the goal of closing the tax gap and reducing the deficit. I strongly encourage this subcommittee and the Congress to find a way to exempt the IRS from any such cuts.

PREPARED STATEMENT OF PAUL CHERECWICH, JR., CHAIRMAN, IRS OVERSIGHT
BOARD, DEPARTMENT OF THE TREASURY

The Internal Revenue Service (IRS) Oversight Board thanks Chairman Durbin, Ranking Member Moran, and members of the subcommittee for the opportunity to present the Oversight Board's views on the administration's fiscal year 2012 IRS budget request.

This statement presents the Board's recommendations for the IRS' fiscal year 2012 budget and why the Board believes this level of funding is needed to meet the IRS needs. Created as part of the IRS Restructuring and Reform Act of 1998, the Oversight Board's responsibilities include overseeing the IRS in its administration, management, conduct, direction, and supervision of the execution and application of internal revenue laws. The Board is also responsible for ensuring that the IRS' organization and operations allow the agency to carry out its mission.

The Board has a responsibility to ensure that the IRS' budget and the related measured contained in the performance budget support the IRS Strategic Plan 2009–2013. In addition to this statement, the Board developed a special report in which it explains the detailed rationale for its budget recommendations. The report is available online at www.irsoversightboard.treas.gov.

FISCAL YEAR 2012 IRS BUDGET RECOMMENDATIONS SUMMARY

The IRS Oversight Board recommends a fiscal year 2012 IRS budget of \$13.342 billion, an increase of \$1.2 billion more than the fiscal year 2010 enacted IRS budget, and an increase of \$709 million more than the President's fiscal year 2011 IRS budget request.

The Board's fiscal year 2012 recommendation is substantially higher than those made in the IRS fiscal year 2010 and fiscal year 2011 budget recommendations due in part to the cost to implement provisions of the Patient Protection and Affordable Care Act (ACA), which totals \$473 million in the Board's fiscal year 2012 IRS budget recommendation. Tables 1 and 2 show more information on the Board's budget recommendations. Table 1 shows the program initiatives or increases the Board is recommending, and Table 2 shows the Board's recommendations budget by account. The Board has also included an appendix to this statement that summarizes new tax law provisions that have placed additional demands on IRS resources during the 2007–2010 filing seasons.

The Board's foremost priority within its fiscal year 2012 budget recommendation is the \$333.6 million in total funding recommended for the Business Systems Modernization (BSM) account, along with an associated \$52 million within the operations support account for information technology infrastructure to support ongoing BSM maintenance.

The Board's second-highest priority is funding of taxpayer service that allows for the restoration of an 80 percent level of service (LOS) on IRS toll-free telephone assistance during fiscal year 2012. The Board believes that additional funding is needed to improve toll-free service, as major changes to the tax laws in recent years have contributed to a substantial increase in the number of calls to the IRS and a corresponding drop in the LOS. The Board notes that it foresees a greater demand for toll-free assistance in the coming years, driven by a proliferation of new tax provisions.

TABLE 1.—IRS OVERSIGHT BOARD RECOMMENDED FISCAL YEAR 2012 IRS BUDGET

	Amount
Fiscal year 2010 enacted budget	\$12,146,123
Fiscal year 2011 annualized continuing resolution Level	\$12,146,123
Maintaining current levels	\$85,754
Efficiencies/savings	(\$189,957)
Base reinvestment: consolidate submission processing Atlanta	\$1,486
Adjustment fiscal year 2011 President's policy level	\$401,665
Fiscal year 2012 adjusted base	\$12,445,071
Improve taxpayer service	\$81,307
IRS.gov improvements	\$33,000
Taxpayer service initiatives	\$114,307

TABLE 1.—IRS OVERSIGHT BOARD RECOMMENDED FISCAL YEAR 2012 IRS BUDGET—Continued

	Amount
Increase international service and enforcement	\$72,596
Increase collection coverage	\$52,000
Implement merchant card and basis reporting	\$35,730
Increase coverage to address tax law changes and other compliance issues	\$96,718
Ensure accurate delivery of tax credits	\$260,293
Administer new statutory reporting requirements	\$58,505
Leverage return preparer	\$16,600
Address appeals workload growth	\$9,100
Implement uncertain tax position (UTP) reporting requirements	\$4,129
Enforcement initiatives	\$605,671
Enhance security and disaster recovery	\$35,000
Update integrated financial system	\$27,500
Leveraging data to improve compliance	\$1,400
Enhance physical security for employees	\$31,057
Implement individual coverage requirement and employer responsibility payments	\$62,477
Attract, retain, and develop a quality workforce	\$20,000
Infrastructure initiatives	\$177,434
BSM initiative: continue migration from aging tax administration system .....	.....
Continue migration from aging tax administration system .....	.....
Health Insurance Tax Credit Administration .....	.....
Total Oversight Board budget	\$13,342,483
President's fiscal year 2012 budget	\$13,283,907
Increase over President's budget	\$58,576
Percentage increase over President's budget	0.4

TABLE 2.—IRS OVERSIGHT BOARD RECOMMENDED FISCAL YEAR 2012 BUDGET BY ACCOUNT

	Taxpayer service	Enforcement	Operations support	BSM	Health Insurance Tax Credit Administration	Total
Fiscal year 2010 enacted budget	\$2,278,830	\$5,504,000	\$4,083,884	\$263,897	\$15,512	\$12,146,123
Fiscal year 2011 annualized continuing resolution level	\$2,278,830	\$5,504,000	\$4,083,884	\$263,897	\$15,512	\$12,146,123
Maintaining current levels	\$12,908	\$30,691	\$41,755	\$168	\$232	\$85,754
Efficiencies/savings	(\$41,333)	(\$21,996)	(\$124,440)	(\$1,026)	(\$1,162)	(\$189,957)
Base reinvestment: consolidate submission processing Atlanta	\$1,486					\$1,486
Adjustment fiscal year 2011 President's policy level	\$23,254	\$242,275	\$10,128	\$122,561	\$3,447	\$401,665
Taxpayer service initiatives	\$44,078		\$70,229			\$114,307
Improve taxpayer service	\$44,078		\$37,229			\$81,307
IRS.gov improvements			\$33,000			\$33,000
Enforcement initiatives	\$25,910	\$209,668	\$370,093			\$605,671
Increase international service and enforcement		\$48,363	\$24,233			\$72,596
Increase collection coverage	\$2,201	\$30,275	\$19,524			\$52,000
Implement merchant card and basis reporting	\$10,475	\$17,495	\$7,760			\$35,730
Increase coverage to address tax law changes and other compliance issues	\$7,229	\$33,936	\$55,553			\$96,718
Ensure accurate delivery of tax credits	\$4,946	\$49,083	\$206,264			\$260,293
Administer new statutory reporting requirements	\$1,059	\$5,061	\$52,385			\$58,505
Leverage return preparer		\$14,240	\$2,360			\$16,600
Address appeals workload growth	\$7,450	\$1,650	\$9,100			\$16,600
Implement UTP reporting requirements		\$3,765	\$364			\$4,129
Infrastructure initiatives	\$500	\$7,911	\$169,023			\$177,434
Enhance security and disaster recovery			\$35,000			\$35,000
Update integrated financial system			\$27,500			\$27,500
Leveraging data to improve compliance			\$1,400			\$1,400
Enhance physical security for employees		\$3,911	\$27,146			\$31,057
Implement individual coverage requirement and employer responsibility payments			\$62,477			\$62,477

Attract, retain, and develop a quality workforce	\$500	\$4,000	\$15,500			\$20,000
BSM initiative: continue migration from aging tax administration system			\$52,000	(\$52,000)		
HITCA						
Total	\$2,345,633	\$5,972,549	\$4,672,672	\$333,600	\$18,029	\$13,342,483

Appendix 1, taken from the Board's Annual Report to Congress 2010, provides a summary of major legislative and administrative tax provisions enacted in recent years and the challenges that each presented to tax administration during the 2007 through 2010 filing seasons. In addition to describing the impacts associated with implementing these provisions, the appendix provides a short assessment of the IRS' performance in implementing many of them made by either the Government Accountability Office (GAO) or the Treasury Inspector General for Tax Administration (TIGTA).

The appendix highlights the many challenges the IRS faced in implementing new tax provisions that affected the last four filing seasons. Expanding taxpayer service and enforcement programs to ensure these provisions were understood and being claimed properly by taxpayers put a significant demand on IRS resources.

The Board's IRS budget recommendation also acknowledges the wide range of new responsibilities under the ACA, such as the administration of new tax credits and additional information reporting.

Resources Needed To Implement the ACA

The detail in Table 3 makes the fiscal year 2012 budget needs for implementing the ACA fully transparent. The IRS has been tasked with a wide range of new responsibilities under the ACA, including the requirements that it:

- Administer new tax credits for individuals and businesses;
- Collect a new excise tax on tanning services and a new fee on certain businesses engaged in the manufacturing and importing of prescription drugs;
- Implement expanded exemption requirements on charitable hospitals; and
- Gather, process, and share additional information reports.¹

The Board concurs with the President's budget request as to what the IRS funding needs are in fiscal year 2012 to responsibly implement the ACA as currently enacted. As shown in Table 3, the fiscal year 2012 funding needed to implement the ACA is \$473 million with a staffing level of 1,269 full-time equivalents (FTEs). The Board's budget recommendation identifies the funds the IRS needs to provide the necessary assistance, enforcement presence, and supporting systems infrastructure to carry out the ACA requirements in an effective manner.

Of the total dollar funding needed in fiscal year 2012 for the ACA, nearly 83 percent is in the operations support account, much of which is for IRS staff, contractors, hardware, and software needed to build new IT systems and to modify existing tax processing systems to accommodate the new ACA provisions.

OVERSIGHT BOARD'S BUDGET PRIORITIES

The Board's budget recommendation for fiscal year 2012 is approximately \$59 million higher than the President's request of \$13.284 billion, a difference of 0.4 percent. The Board firmly believes that its fiscal year 2012 IRS budget recommendation is the minimum imperative for strong and responsible tax administration. The Board's recommendation calls for an overall IRS appropriation in fiscal year 2012 of \$2.35 billion for the taxpayer service account; \$5.97 billion for the Enforcement account; \$4.67 billion for the operations support account; \$333.6 million for the BSM account; and \$18 million for the Health Insurance Tax Credit Administration (HITCA) account.

In the view of the Board, its budget recommendation reflects a proper balance between taxpayer service and tax law enforcement, funds strategic investments to reduce the tax gap and replace antiquated IRS tax processing systems, and furthers other strategic objectives of tax administration such as greater leveraging of Internet capabilities.

¹Enactment of Public Law 112-9 on April 14, 2011 repeals certain information reporting required by the ACA and reduces the funding needed for ACA implementation by \$23.3 million and lowers the entire request by that amount.

TABLE 3.—ACA-RELATED FUNDING AND FTE BY INITIATIVE
 [Dollars in thousands]

	Taxpayer service		Enforcement		Operations support		Total	
	Amount	FTE	Amount	FTE	Amount	FTE	Amount	FTE
Taxpayer service initiatives:								
Improve taxpayer service	\$20,725	150	\$30,582	51,307	\$150			
Subtotal, taxpayer service initiatives	\$20,725	150	\$30,582	51,307	\$150			
Enforcement initiatives:								
Increase coverage to address tax law changes and other compliance issues	\$4,904	46	\$22,784	174	\$45,927	143	\$73,615	363
Ensure accurate delivery of tax credits	\$4,946	49	\$23,015	233	\$199,535	222	\$227,496	504
Administer new statutory reporting requirements	\$1,059	7	\$5,061	48	\$52,385	132	\$58,505	187
Subtotal, Enforcement initiatives	\$10,909	102	\$50,860	455	\$297,847	497	\$359,616	1,054
Infrastructure initiatives:								
Implement individual coverage requirement and employer responsibility payments					\$62,477	65	\$62,477	65
Subtotal, Infrastructure initiatives					\$62,477	65	\$62,477	65
Total, fiscal year 2012 ACA initiatives	\$31,634	252	\$50,860	455	\$390,906	562	\$473,400	1,269

Moreover, the Board's foremost priority within its fiscal year 2012 budget recommendation is the \$333.6 million in total funding recommended for the BSM account, along with an associated \$52 million within the operations support account for information technology infrastructure to support the ongoing maintenance of BSM components that have been successfully implemented. This level of funding for BSM is imperative and requires a \$122.6 million increase in fiscal year 2011 in the base BSM account to achieve the President's policy level—a proposed adjustment contained in both the Board's recommendation and the President's budget request.

The Board assigns top budget priority to BSM funding primarily because of the critical role these resources will play in modernizing the core taxpayer account system for individual taxpayers under the Customer Account Data Engine 2 (CADE 2) program. With the recommended funding, the CADE 2 program is poised to deliver daily account processing by the 2012 filing season, a major milestone in the IRS BSM effort that will yield tangible benefits, such as quicker refunds, to tens of millions of taxpayers. The Board's recommended investments in BSM also lay the necessary technological foundation for other major advancements in IRS efficiency, taxpayer service, and enforcement for years to come—thereby helping to achieve the strategic goals of the agency. Both the TIGTA and the GAO agree that modernizing the IRS' antiquated computer systems, for which CADE 2 is instrumental, is critical to providing improved and expanded service to taxpayers.

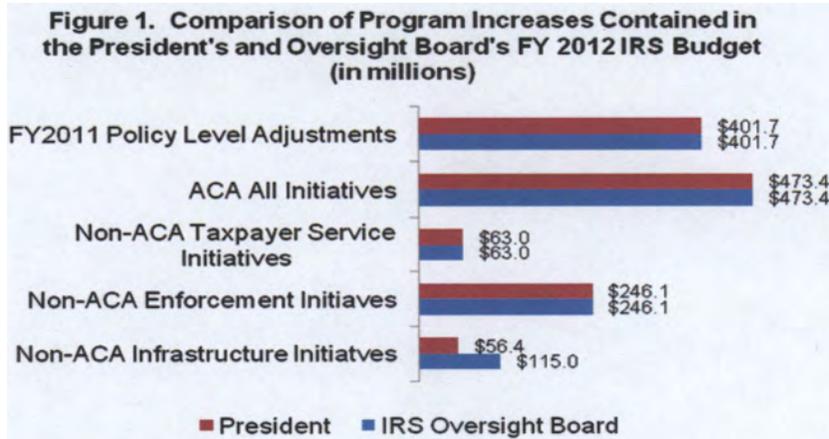
The Board's second-highest priority is funding of taxpayer service that allows for the restoration of an 80 percent LOS on IRS toll-free telephone lines during fiscal year 2012. Achieving this LOS requires both the \$23.3 million increase in fiscal year 2011 to reach the President's policy level and the \$81.3 million initiative in fiscal year 2012 to improve taxpayer service. Recent experience shows that tens of millions of taxpayers still depend on the IRS toll-free telephone operations for assistance in understanding their tax obligations, their eligibility for various tax credits and other tax provisions, or to resolve their account balances. However, major changes to the tax laws in recent years have contributed to a substantial increase in the number of calls to the IRS and a corresponding drop in the LOS into the low 70 percent range. In addition, as more of the provisions of the ACA become effective in 2012, the Board believes that demand for IRS toll-free assistance will grow. Thus, the Board sees it as imperative that the IRS provides taxpayers with an adequate level of telephone assistance in the coming fiscal year; a level the Board believes should be no less than 80 percent. Increased telephone demand, driven by a proliferation of new tax provisions, has prevented the IRS from reaching this level, last achieved in 2007, and the Board believes taxpayers deserve no less in such a complex tax environment.

The IRS has also been tasked with a wide range of new responsibilities under the ACA, such as the administration of new tax credits for individuals and businesses, and additional information reporting. These new responsibilities must be afforded budget priority as well to enable the IRS to properly implement the law. Both the Board's recommendation and the President's budget make transparent the resources in fiscal year 2012 needed to implement the ACA. These ACA funding requirements total \$473 million with a staffing level of 1,269 FTEs. Of the total dollar funding recommended, nearly 83 percent is in the operations support account—much of it for IRS staff, contractors, hardware, and software needed to build new IT systems and to modify existing tax processing systems to accommodate the new ACA provisions.

COMPARISON OF OVERSIGHT BOARD'S AND PRESIDENT'S BUDGET RECOMMENDATIONS

The Board's budget recommendations are largely consistent with the President's budget request in many categories. In particular, inflation adjustments, savings, and reinvestments are identical in both budgets. To facilitate a direct comparison of the Board's recommendations to the President's budget, the Board's budget mirrors the upward adjustments to the fiscal year 2011 base funding to reach the President's policy level. However, it is important to note that these adjustments to achieve the President's policy levels essentially reflect proposed increases to the base IRS budget in fiscal year 2011; increases which had not been enacted at the time the Board and the President prepared their fiscal year 2012 IRS budget recommendations, and which may or may not be realized.

As shown in Figure 1, for its first and second funding priorities, BSM and taxpayer service, the Board recommended budget and the President's budget request are the same. The proposed enforcement budgets, as well as the ACA-related funding, are also the same in both budgets, as is the Health Insurance Tax Credit Administration.



The \$58.6 million difference between the Board's fiscal year 2012 IRS funding recommendation and the President's budget request occurs in three areas. The Board believes that more resources are needed in the area of IRS security and applauds the President's budget request for including two valuable initiatives in these areas: —to improve IRS system security and disaster recovery capabilities; and —another to improve physical security at IRS facilities.

The Board notes that TIGTA has identified security as the top management challenge facing IRS. The Board recommends higher funding levels in both areas. The Board is also recommending an additional initiative not contained in the President's request, which accounts for the third area of difference.

Specifically, the Oversight Board recommends that:

- an additional \$23 million be added to the infrastructure initiative in the President's budget to enhance security and disaster recovery systems capability;
- an additional \$15.6 million be added to the infrastructure initiative in the President's budget to enhance physical security for Federal employees; and
- an additional infrastructure initiative be approved for \$20 million to attract, retain, and develop a highly engaged workforce.

All the budget recommendations by the Oversight Board are driven by the need to support the IRS Strategic Plan 2009–2013. As the Oversight Board has emphasized in its 2009 annual report to the Congress, IRS has a strategic plan that addresses two serious weaknesses of the tax administration system: the tax gap and IRS' archaic information technology systems. The need to overcome these weaknesses, as well as effectively implementing the new tax-related provisions of the ACA drives the Board's IRS budget recommendations.

GOAL 1: IMPROVE SERVICE TO MAKE VOLUNTARY COMPLIANCE EASIER

The President's policy level adjustment and the two taxpayer service initiatives contained in the President's budget request and listed in Table 4. The Board considers its support of the \$23.3 million fiscal year 2011 policy level adjustment for taxpayer service and the \$81.3 million fiscal year 2012 initiative to improve taxpayer service particularly important to America's taxpayers, and has identified them as its second-highest funding priority.

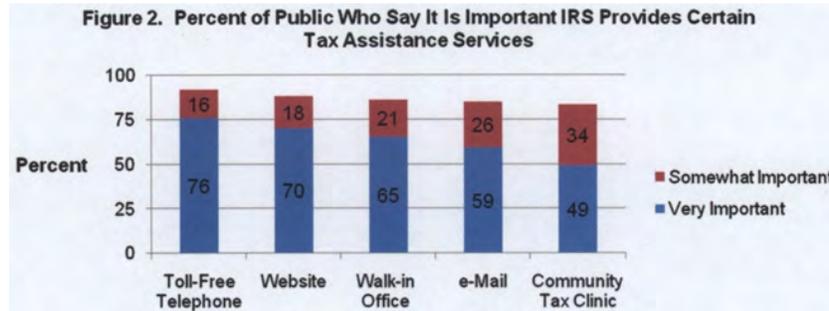
TABLE 4.—TAXPAYER SERVICE ADJUSTMENT AND INITIATIVES RECOMMENDED BY THE OVERSIGHT BOARD AND THE PRESIDENT
[In thousands of dollars]

	Amount	Portion due to the ACA implementation
President's policy level adjustment	23,254	.....
Taxpayer service initiatives:		
Improve taxpayer service	81,307	51,307

TABLE 4.—TAXPAYER SERVICE ADJUSTMENT AND INITIATIVES RECOMMENDED BY THE OVERSIGHT BOARD AND THE PRESIDENT—Continued
[In thousands of dollars]

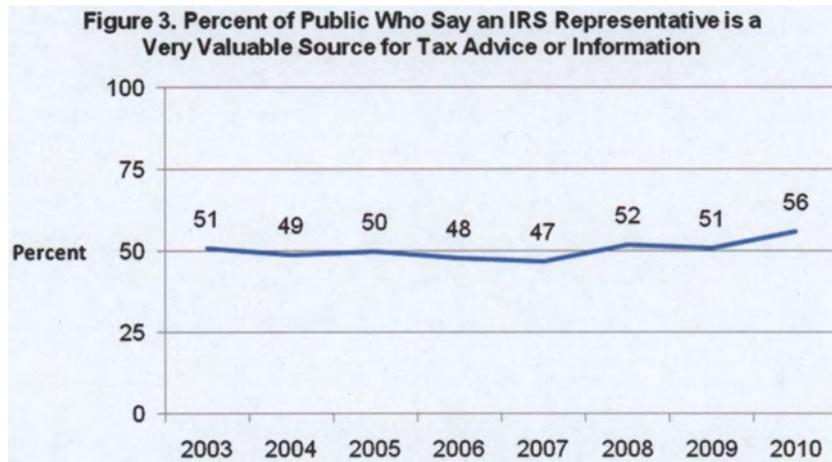
	Amount	Portion due to the ACA implementation
IRS.gov Improvements	33,000	.....
Initiative total	114,307	51,307

Data from the IRS Oversight Board 2010 taxpayer attitude survey attests to the value taxpayers place on the IRS taxpayer assistance programs and the IRS toll-free telephone assistance operation in particular. As shown in Figure 2, more than 80 percent of the public say it is either very or somewhat important that the IRS provide assistance on certain key service channels including assistance via toll-free telephone lines, an IRS Web site, and IRS office locations for walk-in assistance. In most instances, a sizable majority say it is “very important.”



SOURCE.—IRS Oversight Board 2010 Taxpayer Attitude Survey.

The Board’s survey further shows an increase in recent years in the percentage of the public who say that an IRS representative is a “very valuable” source for tax advice. As depicted in Figure 3, that upward trend, beginning in 2008, coincides with the start of major tax law changes designed to spur the economy. Clearly, taxpayers see a growing importance for the assistance the IRS provides through its service programs.

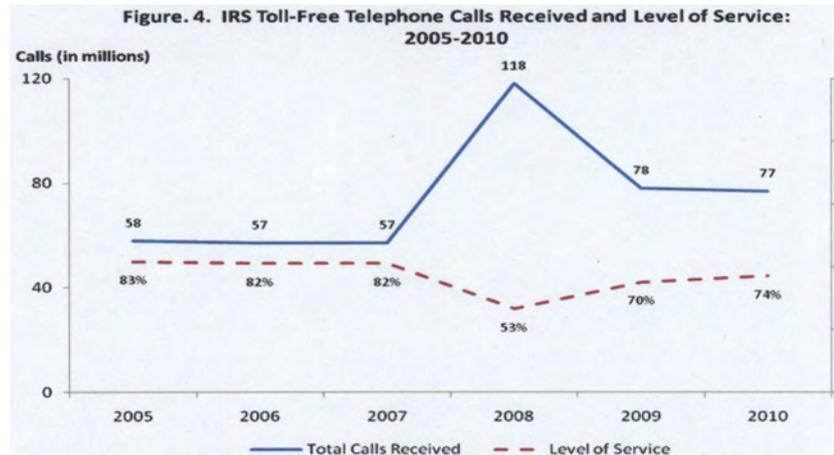


SOURCE.—IRS Oversight Board Taxpayer Attitude Survey.

The Board believes that quality IRS assistance is critical to maintaining and ultimately improving voluntary compliance. Both the fiscal year 2011 adjustment to achieve the President's policy level and the fiscal year 2012 initiative to improve taxpayer service are needed to provide an 80 percent level of service in fiscal year 2012 on the IRS toll-free telephone operations, while maintaining an answer accuracy rate above 92 percent. In the view of the Board, the IRS should be equipped with the resources to deliver no less than an 80 percent telephone level of service. However, the IRS has fallen short of that standard in recent years. Should the Congress and the President agree on an IRS funding level for the rest of fiscal year 2011 that does not include the policy level adjustment, an additional \$23.3 million will need to be added to the fiscal year 2012 initiative to improve taxpayer service.

As indicated in Figure 4, during the 3-year period prior to 2008, the IRS was receiving just under 60 million calls per year on its toll-free assistance lines and delivering a LOS of just more than 80 percent. However, due primarily to major tax law changes, such as those relating to economic stimulus payments, recovery rebate credits, and several other special tax provisions, the number of calls the IRS received rose sharply starting in 2008 and is now nearly 80 million calls per year. This increase in call volume has resulted in a corresponding drop in LOS, which now stands in the low 70 percent range. In looking forward to 2012, the Board seeks to ensure that taxpayers once again receive a minimum 80 percent level of service, addressing not only the slippage that has occurred since 2008, but also the increased call volume that will surely ensue as provisions of the ACA become effective.

The Board also views as an important investment the Expand Online Options Through IRS.gov Improvements initiative to upgrade and expand IRS Internet services. The resources recommended for the IRS.gov Web site reflect a strategic investment that is key to providing substantially better service to greater and greater numbers of taxpayers in the years to come. This initiative furthers one of the guiding principles articulated in the IRS Taxpayer Assistance Blueprint, which calls for the IRS to enhance its Web site so that it becomes the first choice of more taxpayers for obtaining the information and services needed to comply with tax obligations. It also advances one of the core objectives in the IRS Strategic Plan 2009–2013 to deploy advanced information technology tools to improve IRS efficiency and productivity, and to expand online services that improve service and enforcement. In 2010, the IRS recorded more than 304 million page visits on IRS.gov, up from around 268 million visits in 2009, and roughly double the volume experienced in 2004.



SOURCE.—IRS and GAO.

There is little doubt that IRS Internet applications for both internal and external customers are foundational to the success of tax administration. However, the IRS needs to replace its aging and outdated Internet portal environment to improve security and the quality of its Web services. The critical upgrades and expansion of the IRS Web site funded by this initiative are key to achieving the long-term vision for electronic tax administration inspired by the IRS Restructuring and Reform Act of 1998; a vision in which the vast majority of taxpayer interaction with the tax administration system are handled electronically. Moreover, taxpayer services deliv-

ered over the Internet are considerably less expensive than telephone service. Also, investing in an improved Internet capability that eventually lessens telephone volume will result in future savings. In addition, because the Internet is available to taxpayers 24 hours a day, it overcomes a limitation of IRS telephone service.

GOAL 2: ENFORCE THE LAW TO ENSURE EVERYONE MEETS THEIR OBLIGATION TO PAY TAXES

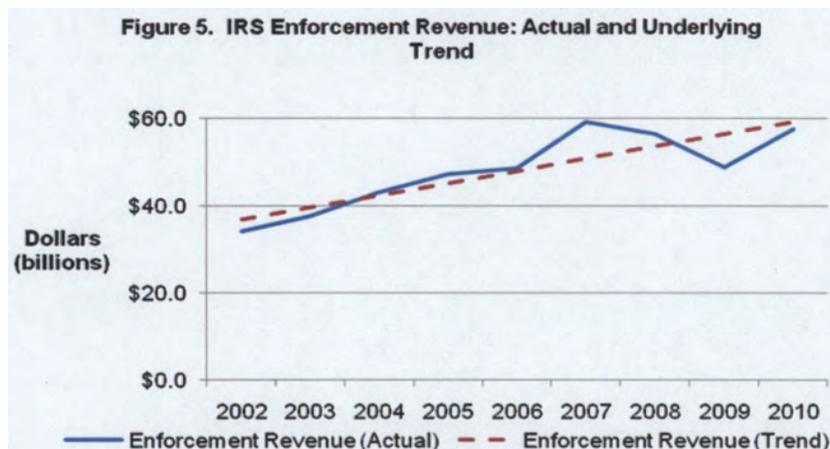
The IRS Oversight Board supports the fiscal year 2011 adjustment and nine enforcement initiatives that are contained in the President's budget and listed in Table 5.

The Oversight Board supports the President's proposed increases in the enforcement area in part because they continue a funding pattern in more recent years that has enabled the realistic and steady growth in enforcement resources; a pattern the Board has consistently recommended. For example, the IRS reports that staffing for its key enforcement occupations of Revenue Officers, Revenue Agents, and Special Agents, has grown from 20,113 in fiscal year 2002, to 21,185 in fiscal year 2006, to 22,710 in fiscal year 2010.

TABLE 5.—ENFORCEMENT ADJUSTMENT AND INITIATIVES RECOMMENDED BY THE OVERSIGHT BOARD AND THE PRESIDENT
[In thousands of dollars]

	Amount	Portion due to the ACA implementation
President's policy level adjustment	242,275	.....
Initiatives:		
Increase international service and enforcement	72,596	.....
Increase collection coverage	52,000	.....
Implement merchant card and basis reporting	35,730	.....
Increase coverage to address tax law changes and other compliance issues	96,718	73,615
Ensure accurate delivery of tax credits	260,293	227,496
Administer new statutory reporting requirements	58,505	58,505
Leverage return preparer	16,600	.....
Address appeals workload growth	9,100	.....
Implement UTP reporting requirements	4,129	.....
Initiative total	605,671	359,616

The gradual growth in enforcement resources has allowed the IRS to increase its enforcement presence among both business and individual taxpayers, and is generally reflected in the IRS enforcement revenue results, which totaled \$57.6 billion in fiscal year 2010. The value of IRS enforcement programs is more than just direct revenue, and year-to-year fluctuations in IRS enforcement revenue occur for various reasons, such as the final resolution of large dollar cases worked over several years. Nevertheless, the clear upward trend in direct enforcement revenue attributed to IRS compliance programs since 2002, as shown in Figure 5, illustrates one tangible result from funding a greater IRS enforcement presence in more recent years.



In the view of the Board, the recommended fiscal year 2011 policy adjustment and fiscal year 2012 initiatives also bolster IRS enforcement operations in a manner consistent with the IRS strategy to reduce the tax gap. In particular, the Board's and the President's recommended funding for enforcement initiatives combines a focus on:

- expanded IRS global enforcement presence relative to business and individual taxpayers with international economic activity;
- efforts to improve the accuracy of return submissions provided through paid tax preparers;
- implementation and leveraging of various new information reporting requirements;
- improved technology tools and increased enforcement staffing to detect fraud and other noncompliance with a myriad of new and existing tax credits, several involving rather substantial amounts; and
- with attention to workload growth in appeals to ensure taxpayer rights are protected.

The Board also notes that more than 40 percent of the total requested amounts for the fiscal year 2011 policy level adjustment and these fiscal year 2012 initiatives are directed toward the implementation of the ACA—most of which are for the investment in new technology and related infrastructure to administer the new tax credits. Among these new credits are those for small businesses to help them provide healthcare coverage for their employees and the new premium credit designed to help millions of other Americans purchase individual health coverage. The Board strongly believes that a balanced approach to the implementation of the ACA requires a proper degree of compliance activity, in addition to taxpayer assistance efforts, to deter noncompliance and fraud.

The Board further notes that while IRS enforcement efforts produce direct revenue, their indirect contributions to voluntary compliance are likely even greater. IRS enforcement presence helps improve voluntary compliance by discouraging noncompliance by those who might otherwise be tempted to under-report their taxes and by giving compliant taxpayers confidence in the tax system and the fairness with which the IRS is administering the tax laws.

To provide further context to the value of improved voluntary compliance, the Board notes that a 1 percentage point improvement in the voluntary compliance rate translates into an additional \$21 billion per year in timely paid Federal taxes, based on estimates for tax year 2001 developed from the IRS National Research program. Some signs of potentially improved voluntary compliance from IRS enforcement efforts can be found in the Board's 2010 taxpayer attitude survey. Respondents who had received an IRS-initiated contact in the prior year, such as a math error notice, were less likely to agree that it is acceptable to cheat on one's taxes (either "a little here and there" or "as much as possible") than were respondents who had not been contacted by the IRS, i.e., 8 percent of the former versus 12 percent for the latter.

STRATEGIC FOUNDATIONS: INVEST FOR HIGH PERFORMANCE IN PEOPLE AND
TECHNOLOGY

Strategic foundations comprise two accounts in the IRS budget: BSM and operations support.

BSM

The IRS Oversight Board supports the total fiscal year 2012 budget of \$333.6 million for the BSM account as contained in the President's budget request and summarized in Table 6. The Board considers its funding recommendation for BSM as its highest priority because it reflects a strategic investment, which is crucial to rectifying one of the fundamental weaknesses in the current tax administration environment, i.e., archaic IRS tax processing systems.

Embedded in the President's request and the Board's recommendation for BSM is an fiscal year 2011 adjustment (increase) of \$122.6 million to achieve the President's policy level. Because the Board considers BSM funding its highest priority, it further emphasizes that if the IRS does not receive the \$122.6 million increase in fiscal year 2011 to achieve the President's policy level, then this amount should be viewed as a Board-recommended fiscal year 2012 initiative for BSM.

TABLE 6.—TOTAL PROPOSED FISCAL YEAR 2012 BUDGET FOR BSM BY PROJECT ACTIVITY
RECOMMENDED BY THE OVERSIGHT BOARD AND THE PRESIDENT

[In thousands of dollars]

BSM projects/initiatives	Fiscal year 2012 budget
Application migration to CADE 2 (taxpayer account database)	156,800
Current CADE	19,000
Modernized e-File	20,500
Core infrastructure	37,700
Architecture, integration, and management	27,645
Management reserve	2,622
Subtotal, capital investment	264,267
BSM labor	69,333
Total, BSM	333,600

The President's request and the Board's recommendations for BSM also include a proposed shift in fiscal year 2012 of \$52 million (following the President's requested policy level increase for BSM in fiscal year 2011) from the BSM account to the operations support account. This shift recognizes that as major components of IRS' aging computer technology are modernized through successful BSM efforts, the ongoing operation and maintenance needs of these components can best be met in the future as part of the funding for existing IT infrastructure within the operations support account.

The information in Table 6 reflects the BSM budget for fiscal year 2012 by project activity, assuming the Board's recommendations and President's request for BSM are enacted. Most of the total BSM budget, including nearly 60 percent of the portion devoted to capital investments, reflect the funds needed for the CADE 2 program. By the 2012 filing season, CADE 2 will provide a modern relational database and daily updating capability for the core tax processing system for individual accounts. The IRS refers to this important milestone as "Transition State 1."

Achievement of Transition State 1 under the CADE 2 program will have immediate benefits to taxpayers, including more timely account balance information to better serve taxpayers and the issuance of quicker refunds to the roughly 109 million individual refund filers each year—a major leap forward from the much smaller pool of about 41 million taxpayers receiving daily account processing today under the more limited "current" CADE system. The CADE 2 funding also enables the IRS to build on its new relational database foundation and begin the work on Transition State 2, which will help address long-standing financial material weaknesses identified by the GAO, and begin the replacement of current service and enforcement applications, based on antiquated computer code, with state-of-the-art, Internet-centric modular applications using modern programming languages.

The annual assessment of the BSM program by TIGTA lends further support to the merits of the requested BSM funds for CADE 2. As TIGTA stated in their assessment issued in September 2010,

“The IRS has refocused the BSM program to deliver the modernized systems sooner. TIGTA is encouraged by the actions planned and taken to refocus the BSM program, especially related to the retooling of the CADE program, known as CADE 2. When successful, the CADE 2 program will provide a significant boost to the IRS’ ability to move away from its antiquated tax return processing systems and provide improved service to taxpayers.”²

The Board’s recommended funding for BSM will help the IRS advance technologically on other fronts as well, such as enabling the IRS to continue further expansion of its successful Modernized e-File (MeF) applications to include the employment series tax returns such as the Form 941, Employer’s Quarterly Federal Tax Return. Extending MeF capabilities to employment tax returns is particularly strategic, for as was emphasized in the Board’s recent 2010 report to the Congress on electronic filing, achieving the IRS long-term goal of an 80 percent e-file rate for all major tax returns will require effective strategies to substantially increase the volume of electronically filed employment tax returns, particularly the Form 941.

The modern relational database to be achieved through the CADE 2 program and the Internet-filing capabilities achieved through the expanding universe of MeF systems, provide the necessary foundations for a new generation of tools and Internet applications that can dramatically improve IRS service and enforcement programs. That is why it so important, in the view of the Board, that policymakers provide the needed BSM funding requested by the President. Indeed, in designating the IRS BSM program as one of the Government programs on its “High-Risk Series” list, GAO has emphasized that the development and delivery of the modernized tax administration and internal management systems are

“. . . critical to providing improved and expanded service to taxpayers and internal business efficiencies for IRS and providing reliable and timely financial management information needed to better enable IRS to justify its resource allocation decisions and congressional budgetary requests.”³

Operations Support

The IRS Oversight Board supports the fiscal year 2011 adjustment in the operations support account and the six infrastructure initiatives contained in the President’s budget request, but also believes more funding is needed. In particular, the infrastructure funding requested by the President and supported by the Board is vital to sensible tax administration including resources needed to improve security for IRS systems and staff; provide for a long-overdue upgrade to the IRS’ obsolete financial management system that currently prevents the agency from meeting Federal accounting standards; and enable the development of the technology and other infrastructure components to implement major provisions of the ACA including new information reporting requirements.

However, while the Board applauds the President’s budget request for including initiatives to enhance IRS computer systems security and disaster recovery capabilities, and to enhance physical security at IRS facilities, the Board believes more resources are warranted. In addition, the Board is also proposing a new initiative not in the President’s budget, which supports a long-term strategic goal for the IRS to be one of the best places to work in the Federal Government. The Board’s recommendations for infrastructure initiatives are presented in Table 7.

TABLE 7.—OPERATIONS SUPPORT ADJUSTMENT AND INFRASTRUCTURE INITIATIVES
RECOMMENDED BY THE OVERSIGHT BOARD
[In thousands of dollars]

	Amount	Portion due to the ACA implementation
President’s policy level adjustment	10,128	.....

²Treasury Inspector General for Tax Administration, *Annual Assessment of the Business Systems Modernization Program*, Reference Number 2010–2094, September 23, 2010.

³The United States Government Accountability Office, *High-Risk Series: An Update*, GAO–11–278, February 2011.

TABLE 7.—OPERATIONS SUPPORT ADJUSTMENT AND INFRASTRUCTURE INITIATIVES
RECOMMENDED BY THE OVERSIGHT BOARD—Continued

[In thousands of dollars]

	Amount	Portion due to the ACA implementation
Infrastructure initiatives:		
Enhance security and disaster recovery	35,000	.....
Update integrated financial system	27,500	.....
Leveraging data to improve compliance	1,400	.....
Enhance physical security for employees	31,057	.....
Implement individual coverage requirement and employer responsibility payments ...	62,477	62,477
Attract, retain, and develop a quality workforce	20,000	.....
Initiative total	177,434	62,477

In relation to the areas where the Board believes more funding is needed for infrastructure initiatives than the President has requested, the Board is recommending an additional \$23 million for the initiative to enhance IRS system security and disaster recovery capabilities (bringing the total initiative request to \$35 million) and an additional \$15.6 million for the initiative to enhance the physical security for IRS employees and taxpayers at IRS office locations (bringing that total to \$31.1 million). The Board is also recommending an initiative of \$20 million to further develop a highly engaged IRS workforce.

Enhance Security and Disaster Recovery Systems Capability

The Board views its two recommendations around enhanced systems security/disaster recovery and enhanced physical security at IRS office locations as highly important to a more robust IRS enterprise risk management strategy. As recent events demonstrate, both natural and manmade catastrophes do occur, so the IRS needs to be prepared—given the critical role tax administration plays in the economic health of this country. Indeed, Homeland Security Presidential Memorandum has designated several core IRS tax processing systems as part of the Critical Infrastructure Protection (CIP) program. In a similar vein, TIGTA in its most recent report to the Treasury Secretary on the top 10 management and performance challenges facing the IRS elevated “security” to the top challenge, in recognition of the difficult task the IRS faces in safeguarding a vast amount of sensitive financial and personal data and also protecting approximately 100,000 employees and more than 700 facilities.

The infrastructure initiative to enhance security and disaster recovery systems capability would address the IRS’ need to provide resiliency of four critical tax systems:

- Processing remittances;
- Processing tax returns;
- Processing refunds; and
- Responding to taxpayer inquiries.

The intent of this initiative is to move the IRS closer to its goal of having a disaster recovery time that does not exceed 12 to 36 hours, dependent upon the system disabled. The IRS’ current disaster recovery capability could leave some systems out of operation for days or even weeks at a time.

Enhance Physical Security for Federal Employees

This initiative will fund guard services for the IRS TACs during the filing season, a period when the IRS employees and taxpayers receiving assistance may be exposed to greater risk of dangerous situations. The initiative will also enable the purchase and installation of security equipment—cameras, screening equipment, and surveillance devices—as another strategy to address areas of vulnerability identified through a thorough security reassessment of all IRS facilities. This initiative will also support the IRS’ full participation on the Joint Terrorism Task Forces (JTTFs) and the Attorney General’s Advisory Counsels (AGACs). It will also train and develop agents to carry out assignments and rapidly follow-up on leads developed by the Garden City Counterterrorism Lead Development Center.

Attract, Retain, and Develop a Highly Engaged Workforce

The Board has approved a long-term strategic goal for the IRS to be one of the best places to work in Government, and will evaluate the IRS’ success in achieving

this goal by comparing its employee engagement score, as measured by the Office of Personnel Management's annual employee survey, to other Federal agencies. Successful achievement of the goal requires the IRS to be in the top quartile among the 14 largest Federal agencies by 2012, based on that employee engagement index score.

The Board believes that it is imperative that the IRS workforce be among the most highly engaged of all large Federal agencies for several reasons:

- The agency is vital to the Nation's economic security.
- More Americans interact with the IRS than virtually any other Federal agency, and the performance of the IRS' employees will have a direct bearing on whether taxpayers' transactions with the IRS are satisfactory.
- Studies have demonstrated that highly engaged employees are the most productive, and increased productivity will be asked of all Federal agencies.
- More productive employees will also lower taxpayer burden through improved timeliness, which studies have shown is a key factor in taxpayer satisfaction with IRS transactions.

Additionally, in the last 2 years, the IRS has hired a number of new employees to replace the growing number of retirees and to increase its enforcement staff. It has successfully recruited highly qualified employees, aided in part by higher unemployment. Retirement rates are expected to remain high in the future, so the IRS will need to continue to recruit highly qualified new employees to replace retired employees, and it must retain those employees it has hired and trained in the last several years. Improving economic conditions will make both these objectives more difficult.

Specific findings by a major IRS operating division indicate that there is a significant benefit associated with high employee satisfaction, all indicating a high degree of efficiency and productivity. Also, attrition by resignation for highly satisfied new employees is significantly lower than for the overall division population.

The proposed initiative will be used to fund activities that have a direct link to increasing and maintaining high levels of employee engagement for front line employees, especially those in mission-critical occupations who deal with taxpayers on a regular basis. Effective first-line management is a critical factor in developing a highly engaged workforce.

The Board is concerned with two issues that relate to developing effective front line managers. First, many highly qualified technical employees are reluctant to move into management. Second, although qualified employees may be highly skilled in their chosen area, they often lack the skills needed to be effective managers and to effectively develop and engage the employees they supervise.

Approval of this initiative would enable the IRS to:

- Eliminate the backlog of untrained front line managers;
- Ensure enough capacity to train new managers upon selection in all business units;
- Improve and expand readiness programs to provide a cadre of candidates to step into management positions;
- Revise the management curriculum to incorporate more e-learning and promote continuous learning; and
- Evaluate the effectiveness and impact of the IRS' leadership programs.

APPENDIX 1.—SELECTED MAJOR LEGISLATIVE AND ADMINISTRATIVE PROVISIONS THAT CREATED SIGNIFICANT CHALLENGES FOR THE IRS DURING THE 2007 THROUGH 2010 FILING SEASONS
2007 FILING SEASON

Legislation/provision and impact(s) on filing season	Some related GAO/TIGTA audit findings
<p>Tax Relief and Health Care Act of 2006 Legislation extended certain existing tax deductions such as those relating to deductions for State and local sales taxes. This late-passed legislation forced approximately 1 million taxpayers to delay their return filing and any associated refund claim for about 3 weeks while IRS finalized its system programs and testing. Required taxpayers to make, and IRS to process, unique annotations on paper tax returns to claim certain deductions.</p>	<p>IRS improved most filing season services during 2007: electronic filing grew and several IRS Web site measures improved such as customer satisfaction; meanwhile, access to IRS telephone assistance and the associated IRS response accuracy were comparable to the prior year (GAO-08-38). Overall, the IRS correctly implemented the key tax law and administrative changes with no significant delays in returns processing during the 2007 filing season (TIGTA report: 2007-40-187). The IRS provided taxpayers with effective access to telephone service; however, the quality and level of service for Spanish applications were lower than those in English (TIGTA report: 2007-40-160). There were some areas in which taxpayers did not take full advantage of the benefits the tax law and administrative changes provided (TIGTA report: 2007-40-187).</p>
<p>Telephone Excise Tax Refund (TETR) Allowed for a one-time refund on income tax returns applicable to all who paid telephone excise tax, regardless of obligation to file a tax return.</p>	<p>The IRS received fewer TETR requests from individuals than expected; early data showed minimal impact on returns processing and taxpayer service (GAO-07-695). With some exceptions, the IRS successfully planned and implemented the TETR program for individuals and businesses; this includes revising forms, developing strategies to educate taxpayers, and developing methods for taxpayers to estimate their TETR claim without burden of obtaining years of telephone bills (TIGTA reports: 2007-30-178 and 2008-30-091). Despite IRS efforts, much of the over-collected tax went unclaimed and unrefunded (TIGTA reports 2007-30-178 and 2008-30-091). The IRS did not scrutinize many questionable TETR claims by individuals because of competing priorities to examine other issues on returns (TIGTA report: 2007-30-178). The IRS effort to identify overstated TETR claims by businesses were ambitious; however, minimum selection criteria for some businesses were inconsistently applied (TIGTA report: 2008-30-091). A TIGTA survey indicated that 27 percent of preparers who did not compute the TETR claim for their business clients due to cost involved were not aware that the IRS had offered a simplified method to estimate the refund (TIGTA report: 2008-30-175).</p>

2008 FILING SEASON

Legislation/provision and impact(s) on filing season	Some related GAO/TIGTA audit findings
<p>Tax Increase Prevention Act of 2007 Legislation extended Alternative Minimum Tax (AMT) "patch" and certain AMT credit offsets. This late-passed legislation forced approximately 3 to 4 million taxpayers to delay their return filing and any associated refund claim for about 4 weeks, while the IRS finalized its system programs and testing.</p> <p>Mortgage Forgiveness Debt Relief Act of 2007 Allowed taxpayers to generally exclude from income forgiven mortgage debt used to buy or improve principal residence.</p>	<p>Overall, the IRS correctly implemented the tax law changes enacted late in the year with no significant delays in the processing of tax returns (TIGTA report: 2008-40-183). The IRS did not achieve its toll-free assistance and level of service performance goals because of the high volume of calls regarding the economic stimulus payments (TIGTA report: 2008-40-168).</p> <p>The amount of forgiven mortgage debt excluded from income could be significant (GAO-10-997). The IRS faced several compliance challenges in administering this complicated tax provision, including limited information on current IRS forms, and return on investment considerations on whether to devote limited IRS enforcement resources to enforce this provision (GAO-10-997).</p>
<p>Economic Stimulus Act of 2008 Mandated that the IRS send stimulus payments to more than 100 million households based on who filed a tax year 2007 during the 2008 filing season. Congressional passage occurred approximately 3 weeks after the start of the 2008 filing season.</p>	<p>As of June 13, 2008, the IRS had generated 129 million economic stimulus payments, totaling more than \$89 billion with an accuracy rate of 99.6 percent (TIGTA report: 2008-40-174). The first stimulus payments were issued via direct deposit on April 28, 2008 (TIGTA report: 2009-40-069). The IRS made significant efforts to ensure eligible taxpayers received their stimulus payment such as sending advance information notices to more than 130 million taxpayers who filed a tax year 2006 return, initiating outreach efforts to retired individuals and veterans who normally have no need to file a tax return, and initiating outreach efforts to individuals whose stimulus payments were returned as undeliverable (TIGTA reports: 2009-40-069 and 2008-40-100). Demand for telephone assistance related to the economic stimulus legislation was unprecedented and led to a significant reduction in IRS telephone service (GAO-08-916T). The IRS decision to reallocate hundreds of IRS collections staff to help address large telephone call demand resulting from economic stimulus legislation resulted in up to \$565 million in foregone enforcement revenue (GAO-08-916T). TIGTA identified \$1.2 million in false stimulus payments that were issued by the IRS in 2008, and another \$138 million that could be potentially released erroneously in 2009 unless the IRS made improvements in its fraud referral process (TIGTA report: 2009-10-049).</p>

2009 FILING SEASON

Legislation/provision and impact(s) on filing season	Some related GAO/TIGTA audit findings
<p>Economic Stimulus Act of 2008 Allowed taxpayers who did not receive the full stimulus payment during the 2008 filing season to receive the unpaid portion on their tax year 2008 return as a Recovery Rebate Credit during the 2009 filing season.</p> <p>Housing and Economic Recovery Act of 2008 (HERA) Provided taxpayers a First Time Homebuyer (FTHB) credit of up to \$7,500 on purchase of home, but required them to repay the credit over 15 years starting in 2011 filing season. While the FTHB credit was initially contained in the HERA, it was subsequently expanded, and the repayment provision eliminated in most instances, under the American Recovery and Reinvestment Act of 2009. American Recovery and Reinvestment Act of 2009 (Recovery Act) Congressional passage occurred approximately 4 weeks after start of the 2009 filing season. Provided taxpayers a revised credit of up to \$8,000 on the purchase of home with need to repay only if home is resold or ceases to be primary residence within 3 years. Allowed small businesses to apply certain 2008 net operating losses against tax liabilities from the previous 5 years. Provided Federal subsidies for State and local bonds, including Build America Bonds (BAB), through certain credit provisions.</p>	<p>Overall, the IRS successfully planned the implementation of the Recovery Rebate Credit and issued approximately \$8.5 billion in credits to approximately 21 million taxpayers (TIGTA report: 2009-40-129). Taxpayers had difficulty determining whether they qualified for this credit and early in the filing season the IRS had already identified more than 5 million tax returns with Recovery Rebate Credit errors (TIGTA report: 2009-40-058). TIGTA found the IRS calculation errors in less than 1 percent of the cases but also identified a programming error, which the IRS took immediate action to correct that could have potentially allowed almost 6 million taxpayers to erroneously claim nearly \$1.6 billion in credits (TIGTA report: 2009-40-129). Legislation did not provide the IRS with math error authority to prevent individuals without valid SSNs from receiving the credit at the time the returns were processed, and as a result the IRS provided more than \$27 million in credits to taxpayers without a valid SSN (TIGTA report: 2009-40-129).</p> <p>The IRS met many of its processing goals during the 2009 filing season, but telephone access remained low due in part to calls about tax law changes; despite the heavy call volume, IRS accuracy remained above 90 percent (GAO-10-225). The IRS had a successful 2009 filing season despite the unique challenges it faced (TIGTA report: 2009-40-142). The varied FTHB credit provisions within the HERA versus the American Recovery and Reinvestment Act may have confused taxpayers and also presented the IRS with significant challenges to ensure the credit was used correctly as authorized. (TIGTA report: 2010-41-069).</p> <p>The 2009 filing season provided challenges for the IRS due to the two significant tax laws that provided a new FTHB credit, and a massive bailout and tax relief package, which entailed 116 different tax provisions (TIGTA report: 2009-40-058). The Recovery Act posed significant implementation challenges for the IRS because it had more than 50 provisions, many of which were immediate or retroactive and had to be implemented during the 2009 filing season (GAO-10-349). The IRS responded quickly to the implementation challenges of the Recovery Act; however, that quick response entailed tradeoffs, such as not making some computer changes to collect data (GAO-10-349). Nearly 30,000 taxpayers may not have claimed the full amount of the FTHB credit to which they were entitled; the IRS agreed to contact the applicable taxpayers to inform them (TIGTA report: 2009-41-144). Despite the fact that the Recovery Act was enacted during the filing season, the IRS issued timely and clear guidance that helped foster compliance with the new NOL provisions; by the end of 2009, the IRS processed approximately 44,000 NOL claims totaling more than \$3 billion (TIGTA report: 2010-41-070). The initial guidance on bonds published by the IRS was quick, complete, accurate, and consistent with the requirements of the Recovery Act (TIGTA report: 2010-11-035). Generally, all complete requests for payment of Build America Bonds (BAB) Federal subsidies were processed accurately and timely by the IRS, and without indications of fraudulent or erroneous disbursements; as of September 2009, State and local governments received almost \$26.4 billion in funding through 315 BAB issuances (TIGTA report: 2010-11-083).</p>

2010 FILING SEASON

Legislation/provision and impact(s) on filing season	Some related GAO/TIGTA audit findings
<p>American Recovery and Reinvestment Act of 2009 (Recovery Act) Provided a Making Work Pay (MWP) credit to working individuals. Increased allowable credit amount for homeowners who make certain energy efficiency improvements.</p>	<p>The IRS dealt with a number of challenges during the 2010 filing season, including significant tax law changes such as the MWP credit (GAO-11-111). The IRS balanced its resources across filing season activities with improvements in some areas but fluctuations in others: electronic filing and IRS Web site visits increased, level of service to callers seeking live IRS assistance improved compared to 2009, and the accuracy of answers remained high; however, average wait time for telephone service increased compared to 2009, and millions of taxpayer refunds were delayed primarily because of the time needed to correct taxpayer errors associated with the MWP credit (GAO-11-111). The IRS implemented the MWP credit in accordance with the consent of the Congress by advancing it to taxpayers through a decrease in Federal income tax withholding rates (TIGTA report: 2011-41-002). The IRS initiated a significant outreach program to inform taxpayers about the change in withholding associated with the MWP credit and its potential to leave certain taxpayers underwithheld and owing taxes at the time they are due (TIGTA report: 2011-41-002). Despite IRS outreach actions, more than 13 million taxpayers were or will be negatively affected by the MWP credit withholding rate changes, including more than 1 million who may face an increase in their Estimated Tax Penalty amount (TIGTA report: 2011-41-002). A survey of taxpayers who appeared to be negatively impacted by the MWP credit withholding changes indicated that most were not aware of the credit or its effect on their taxes (TIGTA report: 2011-41-002).</p>
<p>Worker, Homeownership, and Business Assistance Act of 2009 Extended FTHB credit another 5 months (to April 30, 2010) and allowed a credit up to \$6,500 for certain long-time homeowners purchasing new homes. Provided the IRS with "math error authority" to deny erroneous FTHB credit claims upfront during the IRS return processing phase. Expanded and extended the NOL carry back provisions for businesses.</p>	<p>As of early 2010, the IRS still did not have the ability to identify individuals who received the FTHB credit but who would have some repayment requirements because the home ceased to be their main residence; the IRS was, however, developing a comprehensive strategy to address this issue (TIGTA report: 2010-41-086). In May 2009, the IRS implemented a number of controls to prevent inappropriate FTHB credits claims from being issued before the claims were processed; however, follow-up action by the IRS was still needed on fraudulent and questionable claims processed before the controls were implemented (TIGTA report: 2010-41-069). The IRS timely implementing procedures to identify and reject extended NOL claims inappropriately submitted by Troubled Asset Relief program recipients, but was somewhat late in implementing controls to apply a limit on the amount of the loss carried back to the fifth year (TIGTA report: 2010-41-070). The IRS received millions of calls related to the MWP and the FTHB; approximately 9 percent of all calls received (GAO-11-111).</p>

PREPARED STATEMENT OF COLLEEN M. KELLEY, NATIONAL PRESIDENT, NATIONAL
TREASURY EMPLOYEES UNION

Chairman Durbin, Ranking Member Moran, and distinguished members of the subcommittee, I would like to thank you for allowing me to provide comments on the administration's fiscal year 2012 budget request for the Internal Revenue Service (IRS). As president of the National Treasury Employees Union (NTEU), I have the honor of representing more than 150,000 Federal workers in 31 agencies, including the men and women at the IRS.

IRS FISCAL YEAR 2012 BUDGET REQUEST

Mr. Chairman, the NTEU strongly supports the administration's fiscal year 2012 budget request of \$13.2 billion for the IRS, a 9 percent increase of \$1.1 billion more than the current fiscal year 2010 enacted level. We believe that the President's request will allow the IRS to continue helping taxpayers meet their tax obligations, improve enforcement of the tax law and generate much needed revenue for the Federal Government.

We are particularly pleased the administration's budget request would provide critical increases for IRS enforcement and taxpayer service activities, and would allow the IRS to continue rebuilding its workforce which remains well below mid-1990 levels.

As in previous years, the NTEU also supports the budget recommendations proposed by the IRS Oversight Board which have generally called for additional funding above that requested by the administration. For fiscal year 2012, the Oversight Board has recommended \$13.5 billion in funding for the IRS. We would be inclined to support providing additional funding for the IRS above the administration's request and look forward to reviewing the details of the Board's recommendation.

TAXPAYER SERVICES

Providing quality customer service to the taxpayer is an important part of IRS efforts to help the taxpaying public understand their tax obligations while making it easier to participate in the tax system. Through a variety of channels, the IRS is able to provide year-round assistance to millions of taxpayers, including outreach and education programs, issuance of tax forms and publications, rulings and regulations, toll-free call centers, the IRS.gov Web site, Taxpayer Assistance Centers (TACs), Volunteer Income Tax Assistance (VITA) sites, and Tax Counseling for the Elderly (TCE) sites. These efforts have enabled the IRS continue raising the standard of service to America's taxpayers and assisted in efforts to improve voluntary compliance.

In fiscal year 2010, these efforts helped the IRS meet or exceed 83 percent of the taxpayer service performance targets. In addition, IRS taxpayer service activities were critical to its ability to deliver a successful 2010 filing season during which IRS employees processed more than 141 million individual returns and issued 109 million refunds, totaling \$366 billion and answered almost 36 million calls from taxpayers requesting information on new credits available to them. In addition, the IRS also provided in-person service at its 401 Taxpayer Assistance Centers (TACs) located around the country, for taxpayers to resolve tax issues and receive help to prepare their tax returns. In 2010, 6.4 million taxpayers visited a TAC, 3 percent more than in 2009. Walk-in service at TACs remains popular among elderly taxpayers, those with limited English and computer proficiency, and taxpayers without Internet access.

In addition, during the 2010 filing season, the IRS expanded hours of service at 16 geographically dispersed TACs, and seven were open every Saturday. In 27 locations, low-income taxpayers took advantage of IRS help in the preparation of both their State and Federal tax returns. The IRS held Open House events at 200 TACs and partner sites nationwide to help taxpayers prepare their returns and resolve their tax issues. As a result, more than 31,400 taxpayers were served and more than 7,700 returns were prepared at these events.

The delivery of a successful 2010 filing season by the IRS is all the more impressive as employees delivered these numbers while also being confronted by a variety of challenges presented by implementation of provisions in the American Reinvestment and Recovery Act of 2009, the Worker, Homeownership, and Business Assistance Act of 2009, and increased telephone demand for Economic Recovery Payment inquiries.

We were glad to see the administration's request of \$2.3 billion for taxpayer services acknowledges the good service that IRS employees provided to taxpayers in fiscal year 2010 while also recognizing that additional progress can be made. In par-

ticular, we strongly support the proposed additional funding to improve telephone level of service, improve the IRS Web site and provide a variety of new online services.

In fiscal year 2012, the IRS plans to increase the telephone level of service by adding resources to meet the ever-increasing demand and continuing to make efficiency improvements such as automated self-service applications that allow taxpayers to obtain information on less complex issues such as refund inquiries. These improvements will free up staff to deal with the more complex tax law issues stemming from the passage of new legislation. In addition, the IRS continues to study the effects of services it offers to taxpayers on the Internet, at walk-in sites, and on its toll-free telephone lines as well as exploring the relationships between taxpayer errors and unclear correspondence to aid in the development of new approaches to service.

The NTEU strongly believes providing quality services to taxpayers is an important part of any overall strategy to improve compliance and that the President's request for taxpayer services will enable the IRS to deliver another successful filing season, improve the responsiveness and accuracy of taxpayer service, and support IRS efforts to enhance taxpayer compliance.

ENFORCEMENT

Mr. Chairman, the NTEU believes a strong enforcement program that respects taxpayer rights, and minimizes taxpayer burden, plays a critical role in the IRS' efforts to enhance voluntary compliance, narrow the tax gap and reduce the deficit. In fiscal year 2010, the IRS enforcement efforts brought in almost \$58 billion in enforcement revenue, an 18 percent increase more than fiscal year 2009. In addition, other key IRS enforcement programs continued to show progress over fiscal year 2009. These include a 6 percent increase in collection case closures, a 20 percent increase in Automated Under Reporter (AUR) contact closures, an 8 percent increase in large corporate audits and an 11 percent increase in the number of individual return examinations.

That is why the NTEU was happy to see the administration's budget request would provide a \$462 million increase in funding for the IRS tax enforcement above the current fiscal year 2010 enacted level, including additional resources made available through a program integrity cap adjustment.

This increased funding will enable the IRS to continue strengthening current IRS compliance programs designed to close the tax gap in several areas, including: increasing compliance by addressing offshore tax evasion through more examinations and full implementation of the Foreign Account Tax Compliance Act (FACTA); implementing information reporting requirements approved by the Congress in 2008 to validate income reported by businesses by reconciling their income with their payment card receipts and third-party transactions; and improving tax debt collection coverage and collection processes. The proposal will also allow the IRS to continue to focus on compliance issues and new responsibilities arising from recent tax law changes included in major legislation, including the American Recovery and Reinvestment Act and the Affordable Care Act.

These investments in IRS enforcement programs are expected to generate \$1.3 billion in additional annual enforcement revenue, resulting in a return on investment (ROI) of 6.4 to 1, once new hires reach full potential in fiscal year 2014. In addition, investment in new enforcement initiatives will also encourage voluntary compliance, further increasing revenue. According to the IRS, the deterrence value of these investments and other IRS enforcement programs on voluntary compliance is conservatively estimated to be at least three times the direct revenue impact.

The NTEU strongly supports targeting additional resources to programs that would help close the tax gap, including new initiatives that deepen and broaden the IRS' focus on international tax compliance of high-net-worth individuals and entities. The IRS has demonstrated that targeted compliance resources more than pay for themselves through increased revenues, which has motivated past Congresses to target additional funds to these enforcement activities. In addition to generating additional revenue for the Federal Government, reducing the tax gap will help strengthen public trust in the fairness of the tax system which will positively impact voluntary compliance with tax laws.

PHYSICAL SECURITY

Mr. Chairman, as you know, last February, in what authorities believe was an intentional attack, a pilot crashed his small plane into a building housing almost 200 IRS employees in Austin, Texas, killing 1 employee and seriously injuring several others. This brazen and cowardly attack, serves as a grim reminder of the great

risk that the men and women of the IRS face each and every day in service of this country.

As one of the most public faces of the U.S. Government, the IRS and its employees often bear the brunt of anti-Government rhetoric and threats. According to the Treasury Inspector General for Tax Administration (TIGTA) which is charged with investigating threats and assaults against IRS personnel, more than 1,200 threat and assault cases were referred to TIGTA for investigation between 2001 and 2008. The cases resulted in more than 167 indictments and at least 195 convictions.

That is why the NTEU was happy to see that the administration proposed \$15 million to enhance physical security for IRS employees. This includes \$10 million to expand guard serve at Taxpayer Assistance Centers (TACs) during filing season, \$1.5 million to improve security at IRS facilities around the country, and \$3.9 million to provide additional resources to identify and investigate individuals or entities whose anti-Government or anti-tax rhetoric exhibit behavioral traits associated with domestic terrorism.

The NTEU believes these critical investments will enhance the overall security of IRS employees in the work place, while maintaining open access for the taxpayers that they serve.

CONTRACTING OUT

Mr. Chairman, the NTEU recognizes that in the current fiscal crisis, it is critical that the Federal Government look for ways to maximize its resources and to root out waste, fraud, and abuse wherever they find it. One way in which the NTEU believes that the Federal Government can best accomplish this is to reform the broken competitive sourcing process, and bring contracted work back in-house. By ensuring Federal employees are able to compete for work with contractors on an even playing field, and identifying areas in which the Government could perform this work more effectively and efficiently, the Federal Government will be better able to provide high-quality services and will save taxpayer dollars. The administration has already begun to reform Federal contracting by requiring Federal agencies to cut wasteful contract spending, reduce over-reliance on contractors, and improve oversight and accountability. These efforts are expected to result in \$40 billion in annual savings by the end of 2011 which could be used to ensure agencies have the necessary resources and staffing.

In recent years, the Congress has acknowledged the inherent flaws in the competitive sourcing process and has included language in year-end spending bills that prohibit the use of funds to begin new public-private Circular A-76 competitions for another year. The NTEU strongly believes the current A-76 competition moratorium should be continued for another year until further steps are taken to reform the broken competitive sourcing process that has eroded the ability of agencies to perform many critical functions, and has led to contractors performing work that should be performed solely by Federal employees.

In addition, we would strongly encourage the Congress to continue the current prohibition on the use of funds for private collection agencies through fiscal year 2012. The use of private collection agencies to collect tax debts has repeatedly been shown to be a waste of taxpayer dollars and lead to taxpayer abuse. The 2006 initiative resulted in widespread taxpayer abuse and a loss of almost \$5 million to the Federal Government, after subtracting program administration costs and commissions payable to the PCAs. While the IRS ended the private tax collection program in 2009, it still retains the statutory authority to revive the program in the future.

CONCLUSION

Mr. Chairman, thank you again for allowing the NTEU to provide our thoughts on the administration's fiscal year 2012 budget request for the IRS. We strongly believe that by investing in demonstrably effective enforcement and taxpayer service programs, the administration's request will allow the IRS to provide taxpayers with top-quality service, enhance voluntary compliance, narrow the tax gap, and reduce the deficit.

Senator DURBIN. Thank you very much.

As I mentioned in my opening statement, the IRS deals with a huge volume, processing more than 230 million tax returns and issuing more than 109 million refunds. It's an indication of the challenge that you face, and your people that you work with face, on a regular basis. And, of course, there are going to be cases

where people set out to defraud or cheat the Government in terms of filing these tax returns.

I'd like to call your attention to one that's received some attention over the last year or so. This is the providing of refunds to people who are serving in prisons across the United States. The Treasury Inspector General for Tax Administration reported that erroneous prisoner refund claims are on the rise—up of 44,944 claiming refunds of \$295.1 million in the year 2009.

Even though the IRS has been able to prevent large amounts of these refunds from being issued—256 million were rejected in 2009, this year of the study—the amount of false refunds issued still hit a high of \$39.1 million. Since 2004, when 18,103 false tax returns were filed, nearly \$123 million in fraudulent refunds have been issued to those serving in prison.

Now, I can think of a situation where someone serving in prison may be eligible for a refund. It could happen. But clearly, in this case we're dealing with those ineligible to receive refunds who are trying to defraud the Government. They aren't satisfied with being punished by sitting in prison. They are dreaming up new crimes—at the taxpayers' expense here—to try to defraud the Government.

And so let me ask you at the outset—I understand you've spoken to the U.S. Bureau of Prisons to try to make sure that we can have identification of those prisoners filing these returns. But I also understand that, when it comes to the State prison systems, that your authority to have this kind of information transferred will expire at the end of this year.

Can you tell me what's being done to stop these false claims by prisoners, and what more we can do to protect the taxpayers and the Treasury?

PRISONER CLAIMS

Mr. SHULMAN. Mr. Chairman, it's an issue we take very seriously and we've been focused on. The bottom line is, when we have the name of a prisoner, we can stop the refund from going out, and we do.

The problem is getting the data. And we signed last year a memorandum of understanding with the Federal Bureau of Prisons, so we'll get the data in a format we need so we can put screens in place to block the refund.

I sent letters out to the Governors of the 10 States that have the highest prison populations and the biggest problems here. We've since that time signed memorandums of understanding with seven of those States to get the information. We're in discussions with 17 other States. So, we've seen some progress with States getting us the information so we can block it.

We have a bigger problem with big counties and municipalities, because we need to get information from them. They've got budget constraints; and we need to get the information in a format we can use in December, so we can load it into our system, so that we can put blocks in place for the filing seasons.

What I would tell you—and I think the Inspector General recognized this in the last report—is, we're stopping more, we're detecting more, and we're screening more now.

Senator DURBIN. Are we prosecuting those who file false returns?

Mr. SHULMAN. The biggest hammer that we have is sending someone to jail. And these people are already in jail. And so, what we've been doing in these memorandums with States and the Federal Government—and this is authority you talked about—is sharing tax data, which generally we can't do under 6103 of the tax laws, so that officials can do things like have additional punishment in prisons. Wardens can put a prisoner in solitary confinement and things of that like. Because the people we generally block are people who are there for life. As you mentioned, there's a lot of prisoners who are married, filing jointly, who are due a refund. So, what we need to do is screen the return and make sure we're not hurting the spouse of a prisoner.

I think we've made a lot of progress. This year we've actually processed and done screens and follow-ups of 100,000 more returns. I added resources to the unit that does the screening. And so, all of this is moving in the right direction. And as long as we get the information, we can properly block these refunds.

IMPROPER CLAIMS

Senator DURBIN. In the infinite wisdom of a Member of Congress, we dream up new tax deductions and tax credits for perfectly valid reasons—at least in our opinion. And then it's up to you to try to make it work. And one of them related to tax credits for energy efficient windows, doors and insulation and geothermal heat pumps and solar water heaters. I probably voted for it. I would have if it were a separate vote. It sounded like a good idea.

For tax year 2009, taxpayers claimed more than \$5.8 billion of the energy credits which were included in the 2009 Economic Stimulus Recovery Act. Based on a review of a statistically valid sample of 150 tax returns, the Treasury Inspector General for Tax Administration was unable to confirm home ownership for 30 percent of that sample—45 of the taxpayers—which, of course, is required to claim the credit. So, there is, at least, a question mark going forward as to whether these 30 percent of the people who claimed this money were eligible for it.

In addition, the Inspector General identified 362 ineligible individuals who were allowed to erroneously claim \$404,578 in residential energy credits on their tax returns. These individuals included 262 prisoners—here they are again, now claiming that they deserve a tax credit for energy efficient windows in their prison cells, I guess—and 100 individuals under the age of 18 who were ineligible to file.

So, how do we get to the bottom of this—once again, with the prisoners, and, again, with those who are ineligible—to try to police the ranks and make sure that people aren't filing and claiming credits that they're not entitled to?

Mr. SHULMAN. I think there's a couple of things. This is a worldwide phenomenon. When people wanted to give incentives to spend when there was a major economic meltdown across the globe, people quickly used the tax system to push a lot of money out to help stabilize economies. The tax system is efficient, and there's already an annual interaction that happens every year with most Americans.

When we have time, we can properly set up filters, think this process through, engage with the industry, find out where there's potential leakage, find out what data we can get in, find out what data we can get through on our electronically filed returns, and then set up screens and filters. And we do that. For instance, in the report you referenced, we generally—this law happened very quickly, when we were trying to do some things—set up a set of filters. Our Inspector General—who provides incredibly valuable service, and we learn along the way, I think, both of us, as we go—recommended we put more filters in place while we were having dialogue on that report.

Some leakage occurred. We'd like to have zero leakage. There's going to be some leakage with any credits, because we're only going to be able to screen and follow up with a certain amount. But we do follow-up. And so, when things happen very quickly, sometimes more refunds go out the door that are questionable. Then we have an audit program where we can go audit, find out what's there, do follow-up, and close. If we have a lot more lead time, with more developed credits, we can set up the screens ahead of time.

But make no mistake—I think we're getting better at this, and we've a lot of sophisticated filters, and we stop the vast majority of fraudulent returns from going out. But if you're going to use the tax system, which is built on voluntary compliance, to achieve these goals we've got to get this balance right between getting refunds to people who are due them and rely on them, and blocking the bad ones, there's going to be some leakage. Our goal is to get that balance right—to narrow the leakage as much as we can.

Senator DURBIN. If—Senator Moran, just bear with me. I want to ask two questions to close this line here.

In the most egregious cases, when someone is claiming they're a homeowner and entitled to these credits and, in fact, they're not—

Mr. SHULMAN. Yes.

Senator DURBIN [continuing]. So, they are just clearly misrepresenting their eligibility for the program. It's not a math error. It's a clear misrepresentation. In those cases, when you detect them, is there follow-up in terms of penalties, fines, prosecution?

PENALTIES AND FINES

Mr. SHULMAN. Penalties, yes. Fines, yes. We have limited prosecutorial resources. We try to spend those resources on the places that are going to create the most long-term deterrence. Our Criminal Investigation Division is balancing things around money laundering, terrorist financing, preparer fraud, identity theft fraud, and very specific tax fraud. We try to allocate the resources appropriately.

So the answer is "Yes". And a lot of times, you'll see a scheme where one person puts a bunch of false claims in, files a return, comes back. An individual who claims \$1,000 credit for himself fraudulently usually will be fined in more of a civil context than a criminal context. But the bigger the crime, the more prosecution is likely to happen. And as you know, it's a partnership with the Justice Department and local U.S. Attorneys.

IMPROPER CLAIMS

Senator DURBIN. So, we talked about these jail-cell taxpayers, and I've talked about this specific credit. If you could—the last question here—if you could take a look at the overall landscape, where do we find the most fraud—the most cheating going on in terms of people claiming what they are not entitled to under our tax code?

Mr. SHULMAN. You know, the tax code is incredibly complex. There's a fair amount of noncompliance. Some of it is confusion; some of it's fraud. The places we focus, which is where we think the most leverage is for the tax system to make sure we protect the fisc, is overseas and offshore tax evasion—people just parking assets overseas. I would say, where there's complexity is where people hide money and push the envelope.

We've been focused around preparer fraud, because we think it's a big point of leverage. If one preparer gets 1,000 taxpayers and encourages them to do something fraudulent, a lot of times the taxpayer is unsuspecting. If we can lock that down, it's a big link in the system.

And then refundable credits. In places where you can get a large tax credit, you find fraud. So, we did a lot of focus on the First-time Home Buyer Credit, where there was a big refundable credit that was temporary, that was quick. Earned Income Tax Credit—we put a lot of effort there, doing both civil and criminal follow-up. And then, this set of credits that you talked about, is where we put a lot of effort.

Senator DURBIN. Thank you.

Thank you, Senator Moran, for your patience.

Senator MORAN. Mr. Chairman, thank you.

FRAUD DETECTION

Commissioner, following that line of questioning, how often is it that the IRS finds the fraud, as compared to an Inspector General's report, or a GAO report requested by the Congress? How actively engaged and how successful are you in ferreting out the problem with some, without some other agency pointing out the fraud or the challenge?

Mr. SHULMAN. Every tax return goes through a screen. We call it the Electronic Fraud Detection System (EFDS). It's our fraud filters. And it looks for, for example, returns that have the same address—100 returns that have the same address; big changes in income; not having the proper documentation attached or not including information in the return. We set filters and tolerances, frankly, based on resources. A lot of these are an indication that we need to follow up.

And so, we have civil units that call employers and say, "Was this person employed? Is this income accurate?" And then it kicks out to criminal, who develop schemes, and that feeds our criminal prosecutions.

What I would say is the GAO, our Inspector General, Congressional oversight all really help us by focusing on places where they think we've had too much leakage. I don't think there's been an in-

stance—at least since I have been there—where people have found more fraud in their investigation than we’ve actually blocked.

And so just to give you a sense of magnitude, our EFDS filters, screen filters, kick out between 1 and 2 million tax returns a year that we do follow-up on. We block every year and reject 2 million returns who have duplicate SSNs of either dependents or individuals. And sometimes it’s a transcription error, but sometimes it’s somebody trying to defraud the system. In EITC alone we protect \$4 billion annually through our enforcement efforts and blocking refunds.

We’ve got an incredibly active program there. But then it’s very helpful to have people overseeing the program, finding where they think there’s too much leakage, and we tighten—you know, it’s a continual evolution and tightening up. Frankly, the real fraudsters, they’re always testing our tolerances, sending things in to our systems. And so, we always have to be one step ahead.

PRISONER CLAIMS

Senator MORAN. Well, the two examples that Chairman Durbin indicated—the prisoner example—that’s something you would have known before we read about it in the paper?

Mr. SHULMAN. Well, sure, we’ve had extensive conversations. Look, it’s counterintuitive to your average American that a prisoner could get a tax refund, right? So it’s going to be in the paper.

Senator MORAN. It makes a story.

Mr. SHULMAN. I think the reality is, some prisoners can get tax refunds. We can’t just reject everyone. So we need to do screening.

If you look at the reports that say there’s been more, they also show that we’ve been screening more and blocking more and identifying more. It’s just the volume’s grown, so the gross volume of refunds were higher this year. The numbers, the percentages that we caught, the amount we caught and filtered, also grew exponentially. So, we were protecting a lot more money for the Federal Government. But, as a fraction, more was going out.

Senator MORAN. Okay.

E-FILING

You talked about e-filing and the savings that come from that successful program. Your sentiment—first of all, how much more potential is there for savings? Is there more, opportunity for more e-filing expected? And then second, you talk about the \$190 million in efficiency savings, reductions and nonrecurring activities. What does that mean in the budget and appropriations process?

Mr. SHULMAN. Sure. So, on e-file, just to tell you what we’ve done, we’ve shut down 5 of our 10 processing centers over the last 6 years. It hasn’t been popular with folks where those processing centers were. But, we’ve been very clearly reaping the savings of e-filing. Right now, we plan to get to 80 percent of returns e-filed. We’re at 75 percent. But, certainly, we’re going to look to reap more savings. So, we’re at 75 percent individuals e-filing.

Twenty years from now, my guess is the IRS won’t take any paper. We still take some paper. I am hoping that percentage is just going to keep going up, and that’s been a great success. Really working with the private sector, with individuals, to help them to

understand, we take data security very seriously, so nobody will be worried with those 1 billion returns that there's going to be any leakage.

Since I came here, and for every budget for the last 3 years that I've submitted, we've always included substantial savings. Because I believe, as the head of a big hundred-thousand-person agency, that you can always find efficiencies. You've always got to be looking at core operations, stopping operations that don't make sense so you can keep investing in the future and positioning yourself for the future.

This year, the \$190 million is some savings from e-file. We're just reaping the benefits and cutting down our processing operations; reducing IT infrastructure. We've been going through a process called Capability Maturity Models, which is pretty standard practice in the private sector, where I came from—I used to be involved in helping to run stock markets and run big computer systems—where you standardize your processes across your whole IT infrastructure. So you have standard ways of documenting IT, standard ways of developing requirements. You bring in an outsider to observe—there's a thing called the Software Engineering Institute that will come in and do random audits to see where it is. And we've been promising and reaping benefits, for the last 3 years, \$75 million a year by being more efficient and more standardized. And my Chief Technology Officer has signed up to those savings. And as long as I am here, you're just going to expect it, and we say we're just going to keep doing savings and adjusting core operations. It actually increases efficiency, while saving money.

And then we made some tough choices. This year we didn't automatically send out any paper 1040 forms. E-filing crossed a threshold. We just said, even in the past, if you filed a paper 1040, we didn't send you a paper 1040. I thought that was a self-fulfilling prophecy. So what we did instead this year, we sent you a postcard and said, if you really want your 1040, give us a call and we'll send it to you, but we're not going to spend \$10 million printing and sending out those.

We've cut contracts. I mean, this is just a series of issues. And to be honest, as the chairman said, we've been under a continuing resolution. Because there's inflation in things like rent and other things, it's an effective cut, and we've been doing aggressive cost cutting this year as well, beyond the things we listed in our 2011 budget as cost savings.

Senator MORAN. So, you would be requesting \$190 million more in your appropriations request in your budget request, but for those savings?

Mr. SHULMAN. Correct.

FILING METHODS

Senator MORAN. Okay. What percentage of American individuals file their return with the assistance of a professional preparer?

Mr. SHULMAN. About 60 percent last year. That number is actually going up. And then, another 20 percent use prepackaged software. So, 80 percent of people are using someone in the professional realm to help them with their tax return.

Senator MORAN. And if you use someone in the professional realm, is that an automatic e-file, or are there professional preparers who are still filing paper?

Mr. SHULMAN. One of the things that, if you come out to one of our processing centers you will see—which drives me crazy—is someone who clearly printed, had developed their tax return on a computer, printed it and sent it to us. And I have got people there typing it back into the system after it had already been typed in once. And there's 10 percent error. We've been reducing it, but that is how you have transcription errors, and it's just incredibly inefficient.

And so last year, the Congress passed an e-file mandate for preparers. We started, we've been phasing it in. It gave us authority to have any preparer who files 10 returns, to e-file. This year we started with preparers with 100 returns.

The good thing about e-file, and I think we did this right over the years, is we only got to a mandate once we really had momentum and almost everyone that we could convince voluntarily to send in electronically had gone in voluntarily. And so, over the years we've really increased e-file. And, now there's a mandate that says if you're a professional preparer and you're using software, you're going to need to e-file—unless you get a waiver from your client who really wants to send it in—

Senator MORAN. Thank you.

Mr. SHULMAN [continuing]. On paper.

Senator MORAN. Chairman, I have other questions, but I assume you do, too.

Senator DURBIN. Thanks a lot, Senator Moran.

TAX GAP

So we're in this debate here about our deficit and how we can come up with a savings of \$4 trillion over 10 years, or roughly \$400 billion a year, either in cutting spending or raising revenue. So, that is, kind of, the standard we're using—save \$400 billion.

It's estimated that \$345 billion of Federal taxes go uncollected each year—a noncompliance rate of 16.3 percent. This gross tax gap problem illustrates an enormous untapped resource of Federal revenue which can go a long way to dealing with our shortfalls and our deficit.

Most of the tax gap—\$285 billion out of \$345 billion, or 82 percent—is attributable to under-reporting tax liability, \$197 billion of that from individual income tax payers. Under-reporting can be the result of understated, or, can be understated income, improper deductions, overstated expenses, and erroneously claimed credits.

So, we went through a little exercise here on the Affordable Health Care Act and decided that one way we could capture some of these uncollected tax revenues when it came to small businesses was to have more reporting from them, more 1099s reflecting their business activity. Well, naturally, there was huge push-back from the business community saying, "More paperwork? Thank you, Washington. That is just what we need." And so we back-tracked and walked away from that and said okay, we won't tighten up the system at the expense of more paperwork.

So I want to ask you a pretty obvious question—with a pretty obvious answer, I am sure. Is there a way to address this tax gap without more reporting, more regulation, and more disclosure?

Mr. SHULMAN. Our statistics basically show, when you have information reporting and withholding—like the average American's paycheck, where it's withheld and the employer sends in the taxes and they get a refund—you have more than 99 percent compliance. Where you have some information reporting—mortgage interest deduction, 1099 reporting for interest on bank accounts that kind of thing—you've got 95, 96 percent compliance.

Where you have no information reporting—cash economies, think about cash businesses—the compliance drops. It's hard to do these compliance studies. I mean, they're by their nature inaccurate, because what you don't get, you don't know. But we go out and we do research. We do some statistically selected samples, et cetera—you get 50 percent, 60 percent compliance, 70 percent compliance, etc.

And so the real answer, and the place where there's leverage, is information reporting. But as you said, we set up our tax system as a voluntary tax system, where you're supposed to be fully forthcoming with the Government, report what you know, and then we keep an eye on things. The way that we can have broad coverage and keep an eye on things is having a third party do information reporting. It's the only efficient way to really go at the tax gap. But because it affects a lot of people with the tax code, it becomes pretty politically unpopular, like you said, for example with the 1099 reporting.

So that would have helped with the tax gap, but I fully understand both the politics and the reality around small businesses and what people are trying to do. And so, it's very tough.

There was an economist who's spent a lot of time in tax, who said the thing to remember about the tax gap is, it's like a deep shale oil reserve. This is not just money sitting there that's easily tapped. I mean, we've in many ways tapped the easy money. We actually have a very high tax compliance rate in this country. There's only five countries who study the tax gap, and we're as high as any of them. And the real way to go at the tax gap is better information reporting, but it brings with it some burden.

I do think there's some hope, though, as we get better at information technology, as information becomes more ubiquitous, it's lower cost and easier for people to do reporting. A great example is, this year we're implementing the credit card reporting, where we will get from credit card processors and people like PayPal, gross receipts that were paid into businesses. That's not a direct match, because some industries have high credit card receipts, some industries have lower credit card receipts. We'll look at those statistics, and it will be another factor we use in our audit selection and our compliance selection. And what we try to do with our compliance selection is spend time on noncompliant taxpayers and leave compliant taxpayers alone.

INFORMATION REPORTING

Senator DURBIN. So, I think you answered—I was going to ask a question, if other countries do it more effectively than we do, and

I think what you said, we're in the top five in terms of compliance. So I, if there is an example of another country that has figured out how to do this with greater efficiency in terms of collecting taxes owed, I would appreciate you sharing it.

The second part of it, though, I think you've alluded to. As, we started off with the premise, I receive a W-2 and my 1040 form from the IRS, sit down and dutifully fill it out, sign it, mail it back, and some human being receives this paper and goes through it to see if I'm telling the truth, or it looks presentable—that whole system is starting to change and become paperless. And information is flowing back and forth out without the traditional paper form.

So, are we looking, would you say, looking to a transformation in information gathering, as you just described with credit cards, that may make compliance easier? Where we may not be burdening local businesses so much with filing forms, but rather, having some basic flow-through of information that tells us what we need to know to assume, or, to assert tax liability?

Mr. SHULMAN. I think there's a couple of possibilities. I laid out kind of a long-term vision. We're still quite a ways away from there, because we've got to get some of our core technology done. We're trying to get W2s, 1099s loaded into our system before filing. Right now, the way that all the reporting happens is, those don't get loaded in the system until after people file. We can't use those as screens and blocks. And in some ways, it's back to this refundable credit question.

So I laid out a concept which basically asked if we could figure out a way to front-load the issue—could we potentially work with the private sector and make that information available to people? So rather than people scrambling around and trying to look through their files for those envelopes that say, "Important tax return information," and opening it up and sending it to their accountant or keeping a file of it, we could have a database that would have that.

When people filed, if there was a mismatch, we'd ask them to correct it. It would come in to us. We think we'd have a lot better compliance on the front end, and we'd create a lot less hassle for taxpayers. Right now, if you file and you get it wrong 6 months later you get a letter from us. You then have got to scramble to get your records, go back to your accountant, pay them again, and go through a second loop with us, which is probably unnecessary. So, I think that's one thing we can potentially do.

Second is, I actually started an office, reporting directly to me, on compliance data analytics, which is looking at our databases and trying to make sure we're really smart about the information we have, and that we're applying appropriate treatment streams. So, for instance, we're looking at things like, rather than sending out the standard four letters to taxpayers, which they get over time, making a call to a taxpayer immediately when they have a tax liability, to try to sort things out immediately, much like a credit card company. We are continually looking at data analytics to get better.

I think on the flow-through issue, it's more of a conceptual conversation, and one that we'd have to have a full vetting with the Congress. Because as the 1099 issue showed, people are very sen-

sitive about burden, but people are also sensitive about the voluntary nature of our tax system and the government not knowing too much about people. And so in our compliance job we want to get as much information as we can, again, so we spend time with noncompliant taxpayers and don't spend time with compliant taxpayers.

I just think in the world there's a lot more information available that can move around a lot quicker. And so, there could be less burdensome ways to get that information.

IT CAPABILITIES

Senator DURBIN. My last question is, do you have the information technology capability and the staff capability to develop what we've just discussed—a new generation of thinking about collecting and processing information that doesn't rely on the transfer of paper?

Mr. SHULMAN. Well we've had this conversation. I think we have the staff capability. I would put my IT leadership team that we've recruited up against anybody else in the Government or the private sector. We brought in a CTO who had been head of technology for Boeing, then EDS, then Visa International. He's built an incredibly strong team. And that's why we're able, even under tough budget circumstances, to finally finish this 20-year modernization of our account database.

With that said, where I came from, building big technology and the benchmarks in financial service are, you spend somewhere between 10 and 20 percent of your budget on capital investment in the future and technology, because you're all about processing money, getting information, serving people—which is a very similar model to ours.

Our capital investment, this President had asked to almost double it from 1.5 percent of our budget to about just under 3 percent of our budget. And so my objective view is that this agency, for 20 years, has been underfunded in investing in technology for the future, and we're just getting there. And we recognize the constraints that we're under. And I'm not going to come and make a request for a 10 percent increase in our technology budget, or 10 percent of our budget be technology investment. But I do think the future of running the Nation's tax system is all about investment in technology, investment in information, dealing with information well. And we're going to need to keep investing.

Senator DURBIN. Thank you.

Senator MORAN.

Senator MORAN. Mr. Chairman, thank you again.

1099 REPEAL

The IRS 1099 issue that Chairman Durbin just talked about, as I understand, your budget request included \$23.3 million and 82 full-time employees attributed to that healthcare law's provisions. In light of its repeal, the IRS's request is reduced by that \$23.3 million, and a change in the 180, or, I am sorry, in the 82 full-time employees?

Mr. SHULMAN. Yes. Well, we've—that's dropped.

Senator MORAN. Good. That's the correct answer.

Mr. SHULMAN. We just saved some money.

SECURITY OF TAXPAYER DATA

Senator MORAN. And then, what Chairman Durbin was talking about caused me to want to inquire about the security. You mentioned about the voluntary nature, the concern by Americans about information, the Federal Government having information about them. How secure of a system do we have in place that protects taxpayer information from those who would want to either damage, harm the system, or steal the information for their own use?

Mr. SHULMAN. It is very secure and locked down. I always tell everybody when I was sworn in, I came back to the office, and the first briefing I had as IRS Commissioner was about protection of taxpayer data and data security. It's really built into the DNA of the IRS. There's laws that prohibit any of our individual employees from sharing information about any individual taxpayer with anyone, and we prosecute aggressively when anything happens.

From the just pure data security infrastructure, we've got extensive perimeter infrastructure around the Web, and we're continually monitoring that. We coordinate with all of the Federal and national securities agencies around this issue to make sure our infrastructure is protected.

And then for internal security, we have logs monitoring lockdown. And one of the things that I committed to when I came in, is that any new technology we put online is going to have 100 percent lockdown data security. You have to make choices about what you're going to do, but we're never going to make a choice around data security. So, we take this very seriously and we will stay focused on it.

ACA IMPLEMENTATION

Senator MORAN. One of the reasons—I'll shift topics—but, one of the reasons you would request more money and more personnel is the passage of the ACA. Its constitutionality is being tested and, I assume, ultimately will be decided by the United States Supreme Court.

In light of whatever the uncertainty is, whatever the magnitude of that uncertainty is, is the IRS operating as if it is constitutional and going to be fully implemented? Is there a middle-of-the-road approach? I assume that you've not, or, you're not sitting there waiting for the constitutionality to be determined. But are you behaving any differently in the expenditure of money, the use of personnel, the focus of resources because of the constitutional challenge?

Mr. SHULMAN. Our job is to administer the laws that are on the books. And there's lots of tax laws that are in different places in the courts. This is obviously a high-profile one.

Just to be clear, our responsibility regarding the ACA is to administer traditional tax laws, issue refundable credits, and collect some of the revenues for that. And we are implementing the law on the books. We're in the process of implementing the ACA. If, obviously, if something happens and changes, we'll move. Similar to the 1099 issue that was in there, we would have been prepared to implement that. We had started to do a small amount of planning.

It got repealed, we stopped. But, we move forward with the laws that are on the books.

Senator MORAN. Timeframe wise, for implementation of ACA, what happens incrementally between now and 2014, or, its full implementation? Is there a series of additional use of resources, personnel and tax collections and enforcement?

Mr. SHULMAN. Yes. So, you can really break up the work that we're going to need to do on the ACA into the technology infrastructure, largely around the refundable credits, and connecting with the State exchanges. And that's our biggest lift between now and 2014. Technology and operations are 82 percent of the request in the 2012 budget. It's building the infrastructure to hook up with all the State exchanges, so when people are registering, they can find out their eligibility for tax credits, can sign up for tax credits, and then we have the information flows and the money flows with the insurance companies to be paying those on a regular basis.

And then there's some very bespoke tax law in the ACA that we need to implement immediately. There's a lot of immediately effective provisions, such as an excise tax on tanning salons, which was implemented. And right now we're doing outreach to them. There's 2,500 who have never had an excise tax. And so, we're doing outreach, education, and then we'll have a compliance program.

There's a credit for small businesses to help them buy insurance, or, I mean, to help them buy insurance for their employees. There's a tax on branded pharmaceuticals, which right now we've sent out the initial bills to the branded pharmaceutical companies for that. They're verifying the data. It's actually based on Government purchases. And so there's that kind of work, but that is a very small amount of the work.

So between now and 2014, there'll be the immediately implemented tax provisions and the work that has to happen there. But the big lift is building the technology infrastructure to be ready to interface with the State exchanges and the insurance companies around the refundable, the \$400 billion of refundable credits.

Senator MORAN. And that's required by, in 2014?

Mr. SHULMAN. Yes. The open enrollment will happen sometime in 2013. And if you scope a systems build, you basically need to lock down requirements, then do your build, and then do your testing. So, there's a huge lift in 2012 around requirements and build, because by 2013 you should be testing the systems.

Senator MORAN. Mr. Chairman, I think perhaps my last question is related to Nina E. Olson, the National Taxpayer Advocate's, testimony. And she raised a couple of issues for me talking about, really, customer service, taxpayer service.

TAXPAYER SERVICE MEASURES

The IRS's fiscal year 2010 management discussion analysis included the GAO's financial audit of the IRS. Collection related to enforcement activities totaled \$57.6 billion—a 34 percent increase more than 2004. By contrast, the Taxpayer Advocate noted that the IRS answered 74 percent of all calls from taxpayers seeking to speak with a telephone assister in 2010, as compared to 87 percent in 2004. So, a decline of 13 percent—13 percentage points—or 15

percent. So, less access to the person, the live person on the phone, I think, is the point that's being made here.

And then, also, this sentence that, "the backlog of taxpayer correspondence and the tax adjustments inventory has jumped by 76 percent. The percentage of 'uncontrolled' correspondence received"—I don't know exactly what the word uncontrolled means, but it's in quotes—"uncontrolled' correspondence received but not yet entered into the IRS computer system has increased by 134 percent. And the percentage of taxpayer correspondence classified as 'overreach'"—again in quotes—"has increased by 135 percent."

What are we being told, and what does that mean?

Mr. SHULMAN. As I mentioned at the beginning, I take very seriously that the vast majority of Americans are wrestling with a very complex tax code. Their interaction with us every year is: file a return and get a refund. And that's the last they hear of us. And I think about it, and I talk about it internally at the IRS, as we're a big financial service operation. We need to answer the phones, have a Web site that works, process paper, do all the things that you need to do to serve the American people.

The reality is, we're right now operating with about 1,200 less people than we were at the end of the last fiscal year because we were under a continuing resolution, and our budget was slightly reduced. We have allocations to taxpayer service and we have allocations to enforcement, and those enforcement allocations have a ring around them because they have a direct revenue-producing effect.

The reality, in my mind, is our taxpayer service operations also bring in revenue. When we answer a tax law question, help them get it right, help them e-file, or build computer systems so that we can do matching—all of those actually help get the \$2.3 trillion in revenue.

And we're trying to get a mix of investments.

The phone calls—I think we're actually doing okay. We actually need more people to answer more phone calls. We didn't get the request last year for 2011, and we've put the request in again for 2012, which will bring up that level of service.

I would point out, because we use this thing we call the level of service. That is not: "Is a taxpayer satisfied with the service?" We actually have a 96 percent customer satisfaction rating on our phone calls.

We've introduced a few things, which has dropped our level of service, but we think it increased satisfaction, like wait time. So, if a taxpayer calls and hangs up, that counts as a negative. So, that's not in the 74 percent. But we tell them, it's a 12-minute wait and you might want to call back at a less busy time.

Our paper inventory has been growing because we've had less people processing paper. We either put people on the phones or put people on paper. The way we try to balance it is, during March and April we try to make sure we answer all the phone calls we can, and so paper gets backed up, and then we catch up with paper as we go.

This request asks for more customer service folks because I mean, this, you've got to just process mail. You need people to process it, open it up, look at it, make decisions about where it goes. Things fall out and into error. And so, that's gone down.

I've always leaned and said, around priorities, we want to make sure—technology is the key, and we need to make sure we invest in technology. Phones and paper and the Web—because we can move people off of paper and the phones if we can do more transactions on the Web—have to be invested in. And, frankly, the conversation that ends up happening with people who spend time with the budget is, there's always a tendency to put money into enforcement. And so, we really need—I think you're pointing out and the Taxpayer Advocate's pointed out—we need to keep an eye on a balanced program.

I think the President's budget is very balanced and will get us—will boost those numbers, and so we'll be serving people better. But make no mistake about it. In tough budget times, there's going to be longer wait times; we're going to answer less phone calls; paper is going to take longer.

IRS WORKLOAD

Senator MORAN. Are there more inquiries over time? More taxpayers are calling asking for help? Or less?

Mr. SHULMAN. It spikes based on different kinds of provisions. We had a huge spike in 2008, when we sent out the stimulus checks to every American. People were, "Where's my stimulus check? Am I going to get one?" et cetera. And phone call volume spiked and our level of service plummeted.

We've had kind of steady—and a lot of it depends on tax law, what's going to happen. If you look at our ACA request—just back to what you were talking about—technology and service, and making sure people understand how the rules work, what they're eligible for, is really the bulk of the request.

Senator MORAN. Thank you, Commissioner.

Thank you, Mr. Chairman.

Senator DURBIN. Thank you.

Senator Kirk.

Senator KIRK. Mr. Chairman, you, I, none of us have been accused of ever being in a tanning booth, so I think you can go forward with your outreach without us being affected.

TAX COMPLEXITY

I want to ask about, the Taxpayer Advocate has estimated that it takes Americans about 6 billion man-hours a year to comply with Federal taxes, which, when you divide it out by a full-time equivalent employee, is 3 million jobs, just complying with Federal law. When we look at how people then comply with this law, in a practical way, about 60 percent of the individuals are hiring someone else, about 29 percent of people are interacting with software. It's a hidden tax on Americans of, on average, about \$250 a year. And it's really an extra tax on top of the tax that you pay to comply with Federal law.

Have you thought about a way—it seems to be unreasonable to take 3 million Americans in a country of 300 million to comply with Federal law. Have you thought about a way to develop metrics and then, through software, get it down to 1 million Americans? Maybe just 2 billion hours to comply with taxes, instead of 6 billion? This is an incredible drag on the economy.

Mr. SHULMAN. As you know, the Congress has the prerogative of passing the tax laws. Our job is to administer whatever laws the Congress passes and the President signs.

Senator KIRK. But let me interrupt you on that. There are two ways in the 21st century we can handle complexity. The ideal way, for me, is a flatter, fairer tax, like what the Gang of Six may come up with to lower the rate to 28 percent. But, you know, we'll see.

The other way is entirely in your hands—that an American doesn't pay TurboTax, doesn't pay H&R Block, simply logs onto the IRS Web site and fills out their taxes in an accurate, complete way in which the software is handling all of the complexity. And the amount of time spent complying with Federal law drops like a rock, which is entirely within your purview.

Mr. SHULMAN. We were talking earlier about my view, in looking at the metrics, that we've under-invested in IRS technology for more than 20 years—not in recent history. I will tell you frankly, we don't have the capability. We need to build some things like our core account database, and get that off of a 30-year platform, which we're finishing this year. And so, we need to build some core infrastructure.

We do have available forms that calculate, that people can go in and file online directly with us.

I think there's a big discussion about the IRS having software. And, frankly, it's an administrative discussion. But, it's also a political discussion about—

Senator KIRK. Your total budget is how much?

Mr. SHULMAN. Our total budget is about \$12 billion.

DIRECT E-FILING

Senator KIRK. About \$12 billion.

And, Mr. Chairman, I think something we might work on—because I think Americans would love not to pay TurboTax, and not to pay someone else, just, my guess, correct me if I am wrong—to develop a software package might be a \$20- to \$30-million job? And then put it up on the Web for free to Americans?

Mr. SHULMAN. I mean we've taken some looks at this. I don't think it's quite that simple. And I think there are choices—

Senator KIRK. Actually—

Mr. SHULMAN [continuing]. And I can show you some—

Senator KIRK. I would just disagree. It might actually be even more simple. Because the software companies have to make software calls based on checking with you. Whereas, you actually own all the rules and could be setting up the decision matrix, because you're the authority.

Mr. SHULMAN. I would love, Senator, to talk to you about this further, and I'm happy to talk about it here. I've got lots of letters on both sides of these issues about, should we be in the business of the sets of choices that are embedded in software, or shouldn't we?

What I would tell you is, we've got a very full plate right now of technology investments that we need to get done. That would build the basic infrastructure to start talking about those things, and I would welcome a full-ranging discussion about it.

Senator KIRK. Chairman, I think it might be something that we can work together on.

Because it should—it shouldn't be a theological discussion for you. Your mission should be to make it as easy as possible to comply with Federal law. So, this argument inside your shop should end, like, in an hour.

And then you say, how do we then deploy software in a 21st century context so that an American gets on, puts in their basic data, files, doesn't pay anybody, and, you know, sort of like the E-Verify program—we're making it as easy as possible through an Internet 21st century solution to comply with Federal law.

Thank you, Mr. Chairman.

Senator DURBIN. Thank you, Senator Kirk.

Oh, a call from H&R Block.

Thank you very much for, thanks for—and I don't think that's, I think it's a valid question.

Mr. SHULMAN. Oh, I do too. I totally agree.

TAX COMPLEXITY

Senator DURBIN. If we can eliminate the middleman, the middleman will hate it, but it may save taxpayers money. And if, I'm looking for ease of filing, to be, put another idea on the table—which will never pass as a law—I may have mentioned to you that about 15 years ago my accountant died in Springfield. And I said, come on. I'm a lawyer. I'm a Senator. My tax return is not that complicated. I'll do it myself.

Every Member of Congress should be required to do their own personal income tax return. I guarantee, we'd have tax simplification overnight. Because I struggled with it for hours thinking, why is this so hard? You know? Because I don't do it. And I didn't have a computer program to work with. I was just using my wits. And it didn't turn out to be that impressive.

But the point I am getting to is that the complexity of the system, I think you would agree, needs to be continually reviewed, so that we can make it within the grasp of ordinary Americans to understand how their taxes are being calculated. If there's a mystery associated with it, there is a sense of injustice that I'm paying, and he isn't. You know, that sort of notion. And it is expensive as heck to get some of these tax preparers to do some pretty basic returns. So, I don't think Senator Kirk's off base that, and I want to follow through with it. Let's see what we can do about that.

Senator Moran, do you have anything more?

Senator MORAN. I do not.

ADDITIONAL COMMITTEE QUESTIONS

Senator DURBIN. Thanks for coming. I appreciate it, Commissioner Shulman. We'll have some written questions for you, and maybe some other colleagues will send some along. I'd appreciate it if you'd take a look at them. Thanks.

Mr. SHULMAN. Thank you very much.

Senator DURBIN. Thank you.

[The following questions were not asked at the hearing, but were submitted to the Department for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

REGULATING FEDERAL TAX PREPARERS

Question. Every year, more than one-half of all taxpayers pay someone else to prepare their Federal income tax returns. In calendar year 2009, the Internal Revenue Service (IRS) processed approximately 83.1 million individual Federal income tax returns prepared by paid preparers.

Last year, the IRS launched an oversight program to regulate paid tax return preparers. The purpose of this initiative is to improve the accuracy and quality of filed tax returns and to heighten awareness of preparer responsibilities.

All preparers must now obtain a preparer tax identification number (PTIN) and pass a tax compliance check. Additionally, over the next several years, the IRS plans to establish competency testing and continuing education requirements for preparers.

The fiscal year 2012 budget request for the IRS includes nearly \$17 million to increase oversight of tax return preparers. Among the efforts planned are ensuring that all tax practitioners, tax preparers, and other third parties in the tax system adhere to professional standards and follow the law. In addition, the IRS will develop a public database so that the public can ensure that their tax return preparer is registered with the IRS.

How is the paid tax preparer registration initiative progressing?

Answer. Since September 28, 2010, more than 708,000 individuals have obtained or renewed their PTINs in the IRS Tax Professional PTIN System. The IRS processed approximately 95 percent of the applications online and 5 percent on paper. Per newly implemented user fee regulations, applicants must pay \$64.25 annually for PTINs, consisting of \$50 to recover IRS costs and \$14.25 for third-party vendor costs.

On June 3, 2011 (scheduled to be effective on August 2, 2011) the IRS published the final regulations that amended Treasury Department Circular No. 230 (Circular 230).¹ Some of these significant changes include creation of a new registered tax return preparer designation, extension of Circular 230 ethical rules to all paid preparers, creation of new rules applicable to continuing education providers, expansion of the definition of practice to include return preparation, and numerous other revisions.

In April 2011, the IRS selected two vendors to develop/administer the competency testing and fingerprinting programs. Planning is underway for a projected fourth quarter 2011 launch of both programs.

In preparation for the launch of a new 15-hour annual continuing education requirement for certain preparers, the IRS is gathering information to help revamp the education provider approval process. The IRS is targeting the new continuing education requirement to begin January 2012.

Question. To what extent is the IRS identifying and weeding-out unscrupulous or unqualified tax preparers?

Answer. The IRS is developing a competency test for return preparers. Additionally, we will begin fingerprinting return preparers in order to conduct a suitability check. Fingerprinting will help to insure that those who are entrusted with taxpayer information do not have a criminal history of violations.

The IRS continues to develop and enhance various internal filtering tools to detect egregious behavior and inaccurate return preparation. These tools will enable the IRS to look at aggregate individual return information and extract unique characteristics, identifying likely questionable issues with a return preparer.

We are developing a comprehensive database to house all preparer information, with the goal of detecting unscrupulous return preparers and intervene early. This central database will enable the IRS to track preparers who try to avoid detection through changes in location and varying customers. The IRS is also designing a referral system to investigate and timely address taxpayer and stakeholder complaints surrounding return preparers. The IRS is also developing an aggressive and dynamic identification system for preparers who are being compensated to prepare returns, but who are not properly identifying themselves.

Additionally, the IRS is taking steps to address preparer compliance. Beginning in July, we will begin contacting more than 100,000 preparers who prepared returns in 2011, but failed to follow the new requirements. These preparers either used outdated PTINs or Social Security Numbers as identifying numbers on the returns they prepared. Also, we have identified more than 1 million returns that appear to have

¹Regulations Governing Practice Before the Internal Revenue Service.

been prepared by someone other than the taxpayer, and later this year we will begin to contact those taxpayers to determine who actually prepared these returns.

These initial efforts are part of a comprehensive effort to improve both the way in which the IRS identifies problematic preparers and the methods used to bring them into compliance. Unscrupulous preparers may attempt to elude the new requirements by not signing the returns they prepare. With better data and stronger analytical and historical knowledge, our goal is to ensure all preparers comply with the rules and that unscrupulous or unethical preparers do not continue to prey on taxpayers and the tax system.

Question. To what extent does the IRS plan to assess the impact of tax preparer registration on compliance?

Answer. The IRS has developed a Service-wide preparer compliance strategy to ensure return preparers adhere to the newly implemented registration requirements. The scope of the strategy is to review return preparer compliance with return filings, and includes e-file visitations, return preparer visitations, ghost preparer visitations, and preparer action cases.

This integrated strategy allows for a consistent implementation of the program and assessment of sanctions and/or penalties, and identifies the potential non-compliant/questionable paid return preparers. Through this strategy the IRS will identify the population of return preparers who may have chosen to ignore the new tax preparer registration requirements.

The IRS is also developing a proposed set of long-term strategic measures that will enable the agency to assess the effect of the program on tax compliance. To do this assessment, the newly established IRS Return Preparer Office (RPO) is working with Research, Analysis and Statistics and the Office of Compliance Analytics. The IRS plans to establish a baseline for the measures in 2012 and to track progress from that point.

Additionally, the IRS is developing a proposed set of short and long-term strategic measures that will enable the agency to assess the effect of the program. Short-term measures that could be used to assess program performance using current compliance metrics include the Discriminate Function (DIF) score,² the Dependent Database (DDB) Rule Breaks,³ Risk Scores,⁴ and accuracy measures.⁵ With the exception of the risk scores, the IRS designed all of the other preceding metrics for purposes other than measuring preparer compliance. The newly established IRS RPO is working with the Office of Research, Analysis, and Statistics and the Office of Compliance Analytics to develop longer-term strategic measures. The IRS plans to establish a baseline for the measures in 2012 and to track progress from that point. The RPO will develop this more customized means for measuring the impact of the preparer program over the next 2 to 3 years.

Question. What performance indicators will be used to measure the impact of regulating paid preparers?

Answer. As noted above, the IRS is evaluating current compliance metrics to assess the near-term effect (6–18 months) of the program. Over time, the IRS will develop a more comprehensive measure of compliance that can be more directly tied to the specific education, service, and compliance initiatives of the program.

In the meantime, the IRS is developing indicators to measure the impact of regulating paid preparers. The IRS is still developing the suite of indicators. Indicators may include, for example:

- Number of tax preparers who apply for a PTIN;
- Number of applicants who pass/fail a background check;
- Number of applicants who pass/fail a personal tax compliance check; and
- Incidence of paid preparers misrepresenting professional credential to the IRS and the public.

²The DIF is a mathematical technique used to classify income tax returns as to examination potential. Under this concept, formulas are developed based on available data and are programmed into the computer to classify returns by assigning weights to certain basic return characteristics. These weights are added together to obtain a composite score for each return processed. This score is used to rank the returns in numerical sequence (highest to lowest). The higher the score, the higher the probability of significant tax change.

³DDB Rule Breaks are used to verify eligibility for the Earned Income Tax Credit by determining if a taxpayer is eligible to claim dependents.

⁴The IRS developed a risk-based scoring tool to identify high-risk preparers based on filters that look at volumes and ratios of certain deductions from various schedules.

⁵By using data collected during tax administration processes (math errors, Automated Underreporter (AUR), and the Examination Operational Automation Database), it may be possible to develop a limited accuracy/error rate for individual preparers as well as groups of preparers.

The above indicators are a small representation of those the IRS is developing. However, such indicators focus on outputs rather than on outcomes. The development of outcome measures requires additional time and experience.

The IRS has also developed a Service-wide preparer compliance strategy to ensure return preparers adhere to the newly implemented registration requirements. The scope of the strategy is to review return preparer compliance with return filings, and includes e-file visitations, return preparer visitations, identification of unregistered preparers, and visitations and preparer action cases. Measures are included for each of the strategy's components, which include letters and visits to high-risk preparers, program compliance checks, and identification of nonsigning return preparers.

This integrated strategy allows for a consistent implementation of the program and assessment of sanctions and/or penalties, and identifies the potential non-compliant/questionable paid return preparers. Through this strategy the IRS will identify the population of return preparers who may have chosen to ignore the new tax preparer registration requirements.

Question. Does the IRS expect to be able to cover the costs for the entire registration program with user fees or will you need to depend on existing compliance funds to support the program?

Answer. The user fees are necessary to recover the costs to the IRS that are associated with administering the PTIN application and renewal program, undertaking the fingerprinting and testing requirements, and providing the special benefits that are associated with obtaining a PTIN. The costs to the Government include:

- the development and maintenance of the IRS information technology system that interfaces with the prime contractor's systems;
- the development and maintenance of internal applications;
- IRS customer service support activities, which include development and maintenance of an IRS Web site and call center staffing; and
- personnel, administrative, and management support needed to evaluate and address tax compliance issues, investigate and address conduct and suitability issues, and otherwise support and enforce the programs that require individuals to apply for or renew a PTIN.

User fees do not support traditional compliance activities. In fiscal year 2012 the IRS requested funding for initiatives that focus on preparer activities and utilize traditional enforcement actions currently conducted by IRS personnel.

BUDGET CONSTRAINTS AND FORECAST IN THE FACE OF CUTS

Question. In the final continuing resolution enacted for fiscal year 2011, funding for the IRS was maintained at the fiscal year 2010 enacted level, which was \$487 million below the requested level.

What initiatives planned for fiscal year 2011 were put on the back-burner as a result of the reduced level?

What are the consequences of deferring or not being able to address the resource needs contemplated in your fiscal year 2011 funding request?

Answer. Due to the reduced funding in fiscal year 2011, the IRS will not realize the projected new hires who would have reached full performance potential by fiscal year 2013; therefore, the IRS will collect \$1.9 billion less in Federal revenues per year due to a diminished ability to fairly enforce tax law. As a rule of thumb, for every \$1 spent on additional enforcement initiatives, the IRS would have collected about \$7 in revenue or more at full performance, so these cuts actually add to our Federal deficit. American taxpayers will also see a diminished level of telephone service as a result of these cuts. Specifically, the following initiatives were put on the back-burner as a result of the reduced level:

International.—Without the funding to hire additional staff, the IRS estimates that it will not collect an additional \$812.2 million in enforcement revenue that would have been collected once the new fiscal year 2011 hires reached full potential in fiscal year 2013. Furthermore, the IRS was unable to increase data capture from certain paper returns that would have improved identification of abusive transactions using complex enterprise structures, and was unable to increase the capacity to support law enforcement efforts to investigate and address multi-jurisdictional tax evasions.

Examination.—Without the additional planned staff in field examination, specialty tax (matters that involve the excise, estate and gift and employment tax programs), correspondence examination and Automated Underreporter, the IRS estimates that it will not collect an additional \$659.6 million in enforcement revenue that would have been collected once the new fiscal year 2011 hires reach full potential in fiscal year 2013.

Collection.—Without the additional staff the IRS planned to hire in field collection and the Automated Collection System (ACS), the IRS estimates that it will not collect an additional \$474.4 million in enforcement revenue that would have been collected once the new fiscal year 2011 hires reached full potential in fiscal year 2013.

Increase Telephone Level of Service (LOS).—Without the additional funding, the IRS will deliver a 71 percent LOS in fiscal year 2011, instead of the 74 percent LOS achieved in fiscal year 2010.

Question. The IRS has outlined a handful of ambitious high-priority performance goals for fiscal year 2012. These include achieving 4.5 million document matching closures (where the IRS information does not match taxpayer reported information), ensuring 80 percent of individual taxpayers receive refunds on a 5-day cycle in the new customer account engine database; attaining an individual income tax filers' American Customer Satisfaction Index score of 70 percent; improving telephone level of service to 80 percent; and raising the individual e-File rate to 76 percent.

How might these goals and your proposed IRS priorities for fiscal year 2012 be impacted and IRS operations affected if the additional resources you seek aren't addressed given the austere fiscal projections?

Answer. Without the funding requested in fiscal year 2011 and fiscal year 2012, the IRS will have to delay/reduce program priorities, identify alternative funding sources, and/or decrease base resources in other programs to implement mandatory legislation, such as the Foreign Account Tax Compliance Act, Merchant Card and Basis Reporting, Tax Return Preparer, and the Affordable Care Act. Furthermore, the IRS may be unable to:

- Deliver an 80 percent telephone LOS;
- Replace the outdated Web portal environment and provide additional online services to taxpayers;
- Expand global high-wealth coverage, and further its global presence and pursuit of offshore tax and financial crimes;
- Increase coverage in ACS and Offers in Compromise collection programs;
- Develop a comprehensive and integrated compliance strategy for administering refundable credits and addressing refund schemes;
- Address increasing workloads in Appeals and Counsel;
- Enhance security and disaster recovery systems capability;
- Upgrade the Integrated Financial System;
- Improve compliance by leveraging data;
- Enhance physical security for employees; and
- Continue migration from an aging tax administration system.

CAPTURING ADDITIONAL SAVINGS

Question. The IRS found \$75 million in savings for 2012 through reductions in information technology (IT) infrastructure. These savings were identified through a systematic process to which several staff were dedicated.

Can the IRS apply this systematic approach agency-wide to identify more savings?

Answer. The IRS uses a variety of approaches to identify savings, including soliciting ideas from front-line employees, establishing task forces of agency subject-matter experts, conducting analysis of existing programs, streamlining existing processes, and directing detailed analysis to determine the need and the effectiveness of each program. In addition to the approaches listed above, in the annual internal instructions and guidance for the budget submission, the IRS will continue to look to the business units to identify specific and achievable savings and efficiencies.

Question. What is your reaction to the suggestions by the Government Accountability Office (GAO) that the IRS may be missing savings opportunities and that the costs of conducting periodic reviews on other select aspects of the budget, targeting areas with high potential for savings and efficiencies, could be offset by the savings that are identified?

Answer. The IRS remains committed to exploring additional areas for savings and efficiencies as is evidenced by the identification of \$190 million in savings and efficiencies in both the fiscal year 2011 and fiscal year 2012 budgets, and will continue to employ new approaches to identify opportunities for further savings, balancing the cost with the expected benefits.

IMPROVED UTILITY OF BUDGET REQUEST: GAO RECOMMENDATIONS

Question. Because of the size of the IRS's budget and the importance of its service and compliance programs for all taxpayers, the subcommittee requested that the GAO to review the fiscal year 2012 budget justification for the IRS.

In its April 11 report (GAO-11-547), the GAO stresses that several of the open matters for the Congress or recommendations to the IRS have the potential to increase revenue or savings if implemented.

To improve the usefulness of the budget request for the IRS, the GAO recommends that the IRS take the following four actions:

- further expand efforts to systematically identify savings and efficiencies as part of its budget development process on a periodic, but not necessarily annual, basis;
- report in its budget justification how savings beyond projections were used. The amount of explanation provided should correspond to the amount of the savings;
- provide cost estimates for individual legislative proposals in future budget justifications; and
- include measures of cost and schedule performance for major IT systems in Operations Support, such as it does for Business Systems Modernization (BSM).

What is the IRS's reaction to the findings and recommendations of the GAO?

Answer. The IRS appreciates and agrees with many of the GAO recommendations. The IRS agrees to the following:

- Continue to expand efforts to systematically identify savings and efficiencies throughout the budget process;
- Include in future budget submissions actual savings and to identify how additional savings beyond projections are utilized;
- Provide costs for individual legislative proposals in future budget submissions for those proposals received in sufficient time to prepare the cost estimates; and
- Provide cost and schedule performance for major IT systems in Operations Support in future budget submissions.

Question. Are the GAO's proposals for enhancing your budget presentation reasonable ones and worthwhile for inclusion in your fiscal year 2013 budget submission?

Answer. The GAO's proposals for enhancing the IRS budget presentation appear reasonable and the IRS will strive to include them as a part of the fiscal year 2013 and future budget submissions.

MEASURING ROI

Question. In this year's congressional budget justification, the IRS estimates the ROI for six proposed new enforcement initiatives.

The fiscal year 2012 budget includes \$339 million in new IRS enforcement initiatives, which raise \$1.3 billion in revenue annually at full performance. This is a ROI of 4.5 to 1 when new hires reach full potential in fiscal year 2014.

The GAO has consistently recommended that the IRS compile actual ROI outcome data that could be compared to the original projections.

How much progress has been made developing actual ROI's to measure the effectiveness and success of initiatives previously funded to determine if the anticipated revenue was reaped, exceeded, or fell short of projections?

Answer. The IRS has made progress in measuring the effectiveness and success of the fiscal year 2009 and fiscal year 2010 initiatives. The IRS is able to compare the actual revenue collected (adjusted for the late hiring of the fiscal year 2009 and fiscal year 2010 initiative staff) to the projected revenue expected from the initiatives' hires in the three major enforcement functions—Examination, Collection and AUR. As the table below shows, in fiscal year 2010, the enforcement revenue collected exceeded fiscal year 2009 collections by \$8.7 billion, or \$7.5 billion once initiative revenue is removed. The large increase in fiscal year 2010 can be attributed to several factors—new initiative hires, closing of several large cases, and continued implementation of better case selection and case analysis tools.

[In millions of dollars]

Actual enforcement revenue collected	Fiscal year 2009	Fiscal year 2010	Additional revenue collected (fiscal year 2010—fiscal year 2009)	Fiscal year 2009	Fiscal year 2010	Revenue projected from initiatives ¹	Revenue collected above/below prior year level
Examination	17,446	23,563	6,117	179.5	414.7	594.2	5,522.8
Collection	26,871	29,105	2,234	58.7	258.9	317.6	1,916.4
AUR	4,569	4,924	355	47.4	239.8	287.5	67.5
Total	48,886	57,592	8,706	285.9	913.4	1,119.3	7,506.7

¹ Adjusted for staggered on-board of hires.

Question. The IRS is currently developing a methodology to compare actual costs to projected costs so that a ROI can be calculated for the three major enforcement functions.

Would it not be prudent and helpful to determine the extent to which your revenue forecasts were accurate and the yield was realized?

Answer. The IRS agrees it would be ideal if the IRS could determine the exact accuracy for its revenue forecasts.

It is important to recognize the actual revenue collected is affected by many external and internal factors such as the economy, implementation of new legislative proposals, enforcement resources, changing priorities, and implementation of new case selection and case analysis tools.

Question. Assuming that the Congress is able to provide these resources as requested and that the IRS proceeds with the initiatives as planned, how will we know whether this was a wise investment?

Answer. The specific answer depends on the initiative. Some initiatives relate to short-term revenue-producing activities, which can be measured by program performance and compliance results. Others are longer-term and strategic, with a larger payback in the long-run, but are more difficult to measure in the early years. In either case, the IRS articulates, for each initiative, suggested measures or indicators for what the initiatives will deliver, which can serve as the basis for evaluating these initiatives after the fact.

IT FUNDING: COST AND SCHEDULE INFORMATION

Question. The IRS seeks \$2.67 billion for IT funding in fiscal year 2012, of which \$333.6 million (12.5 percent) is for BSM and the \$2.3 billion (87.5 percent) is for Operations Support.

The IRS funds 155 IT systems. Of these, about 31 are considered “major,” each having an overall life-cycle cost of greater than \$50 million or an annual budget of greater than \$5 million. The other 124 systems are “non-major.”

The GAO’s review of the systems funding justification notes the lack of cost and schedule performance information for the bulk of the IT funding.

Can the IRS undertake the formulation and submission of better estimates for at least some of the major systems?

Answer. The IRS plans to provide cost and schedule performance for major IT systems in Operations Support in future budget submissions. A Treasury and OMB reporting system for all major IT investments already contains the cost and schedule data. In the future, the IRS will utilize an extract to provide the information for the congressional justification.

Question. What factors or circumstances hamper the IRS’s ability to develop such estimates?

Answer. As part of budget formulation process, the IRS currently develops high-level estimates of cost and schedule for each major and nonmajor IT investment. Once the Congress enacts the fiscal year appropriations bill, the IRS completes the process by developing the more detailed cost and schedule plans. The timing and resources required hinder the IRS’s ability to develop more detailed estimates before the enactment of appropriations.

During the initial design stage, the IRS uses a tool to produce a Rough Order of Magnitude (ROM) estimate. After that ROM exercise, the IRS follows-up with a rigorous estimation analysis, updated during the passback cycle. On average, a full costing exercise takes 55 business days, three full-time equivalents and participation of multiple IRS business unit representatives. This analysis can be completed prior to the enactment of the appropriation, but generally would not be captured in time for inclusion with the budget submission.

Each year the IRS identifies in the internal budget formulation process new IT investments required to implement legislation and other IRS strategic priorities that become part of the President’s budget request. The IRS submits proposals and develops cost estimates based on past experience with similar projects. The IRS includes cost estimates by major category (i.e., labor, contractor costs, equipment, software, etc.) in the cost tables that are part of each initiative justification.

Once the Congress appropriates funding for the new IT projects, the IRS develops detailed requirements, cost and schedule information. This information is available at ITDashboard.gov.

VOLUNTEER INCOME TAX ASSISTANCE (VITA) SCOPE EXPANSION

Question. Almost all businesses (more than 90 percent) start as a sole proprietorship or self-employed businesses. Unless incorporated or part of a partnership, self-employed business income is subject to taxation through calculations performed on

“Schedule C” (or C-EZ). Each year, approximately 20 million self-employed businesses file a Schedule C or C-EZ.

In August 2010, the IRS, in partnership with the National Community Tax Coalition and Self-Employed Tax initiative, launched the Schedule C VITA Pilot for the 2011 tax season.

The pilot is designed to determine the feasibility of restructuring IRS policies governing self-employment tax preparation at VITA sites. The 12 VITA sites involved in the pilot are exploring the expansion of service delivery to low-income, self-employed individuals.

What are the preliminary results of the Schedule C VITA pilots?

Answer. There are 24 sites participating in the Schedule C VITA pilot. Preliminary results indicate a total of 3,216 Schedule C returns filed at those 24 pilot sites from January 1 to June 6, 2011.

Question. When will a complete assessment be available?

Answer. IRS will share the complete assessment with participating stakeholder partnerships, education, and communication partners by July 31, 2011. Additionally, IRS will have a summary of the results by mid-August.

Question. Does IRS plan to extend and expand the pilot more broadly to other VITA sites to expand the program reach to small businesses?

Answer. IRS is still waiting for the final report results.

CONCLUSION OF HEARINGS

Senator DURBIN. This will conclude the hearings for this fiscal year and the subcommittee will stand in recess.

[Whereupon, at 11:34 a.m., Wednesday, June 8, the hearings were concluded, and the subcommittee was recessed, to reconvene subject to the call of the Chair.]

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