Testimony of

Diego Ruiz
Executive Director
U.S. Securities and Exchange Commission

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Chairman Davis, Congressman Marchant, and members of the Subcommittee:

Thank you for the opportunity to appear before you today to provide you with background and related issues concerning the SEC's pay-for-performance system. The SEC is in the midst of phasing-in a new pay-for-performance system that was developed in cooperation with the National Treasury Employees Union (NTEU). The SEC believes that this new system will provide meaningful rewards to employees for strong performance, and will facilitate the accomplishment of the SEC's statutory mission to protect investors, promote capital formation, and foster market efficiency.

In order for the Committee to put into proper context the SEC's pay-for-performance system, first let me briefly outline its evolution, including: (1) the circumstances that led to the SEC's decision to seek pay parity; (2) the September 4, 2007 arbitration decision; and (3) where, in light of that decision, the SEC stands as we move forward with pay-for-performance supported by a revised performance management program.

Establishing Pay Parity

Prior to 2002, the SEC experienced significant difficulties recruiting and retaining mission critical staff. These difficulties, in part, were due to disparities between SEC salaries and those of other financial regulatory agencies as well as between the SEC and the private sector. These difficulties are well documented in reports and testimony previously presented to Congress.

In response, the SEC employed compensation programs such as recruitment bonuses, retention allowances, performance cash awards, and special pay rates. However, these programs did not go far enough to help us attract the talent needed nor did they significantly reduce the Commission's attrition rates.

In response to this chronic problem, in December 2001, Congress passed the Investors and Capital Markets Fee Relief Act (Pay Parity Act). The Pay Parity Act authorized the SEC to increase its pay and benefits to levels comparable to those of other financial regulatory agencies while adhering to merit system principles. The SEC, with the support of the Office of Management and Budget (OMB), obtained additional funding to implement a new compensation system that would improve base pay while increasing accountability by linking pay increases to individual performance. As a result of the legislation, the SEC transitioned from the General Schedule to a compensation system consisting of 17 pay grades with up to 31 steps in each grade, which helped to maintain the flexibility needed in compensating a wide variety of professional and support staff within the agency.

Negotiations with the NTEU

In early 2002, after the development of the new compensation and pay-for-performance systems, the SEC and the NTEU entered into compensation negotiations but were unable to reach agreement. The parties disagreed over several aspects of compensation including how employees would be converted into the new pay structure and the type of pay-for-performance system that would be implemented. Subsequently, the matter was submitted to the Federal Service Impasses Panel (FSIP), and in November 2002, the FSIP issued a Decision and Order that supported the SEC's arguments and the substance of the SEC's proposal, concluding that the SEC's compensation proposal was the "product of extensive research carefully tailored to meet the specific needs of the SEC" and that comparability and overall fairness were established. (*Securities and Exchange Commission and National Treasury Employees Union*, 02 F.S.I.P. 122 (2002)).

Among other requirements, the FSIP Order allowed the agency to provide an annual merit increase based on individual performance, and stated there shall be no automatic within-grade increases. Further, the Order stipulated that to be eligible for a merit increase, an employee must meet an acceptable level of performance based on standardized factors developed and tailored for each office and division in the agency.

The overall results of the Panel's 2002 order proved to be quite positive. While no compensation system is perfect, the system was effective in improving recruitment and reducing attrition while enhancing overall organizational effectiveness.

Sarbanes-Oxley Act of 2002

In the same year that the SEC obtained pay parity, the SEC's mission was expanded by the enactment of the Sarbanes-Oxley Act (SOx). SOx mandates a number of reforms to enhance corporate responsibility and financial disclosures, and combat corporate and accounting fraud. It directed the SEC to review all public company disclosures on a specified "regular and systematic basis for the public investor." It also created the Public Company Accounting Oversight Board (PCAOB), to oversee the activities of the auditing profession, and charged the SEC with oversight of the PCAOB.

The additional responsibilities and requirements of the Act demanded a corresponding increase in the SEC's mission critical staff. The SEC's relatively new compensation system proved its effectiveness by allowing the SEC to increase staffing by a third in less than twelve months in order to administer the Act. Furthermore, since the current compensation system was established by the Panel's Order, attrition rates dramatically fell to around 6 percent, which was a ten-year low for the SEC and well below government-wide averages.

Two-Tiered Performance Management System

As part of the SEC's continuous reassessment and refinement of the pay-for-performance system, in May 2003 the SEC issued a performance management policy to: (1) establish fair and equitable performance expectations and goals tied to improving organizational effectiveness in accomplishing the SEC's mission and goals; (2) encourage and facilitate communication between supervisors and employees; (3) effectively evaluate employee performance, identifying strengths and weaknesses; and (4) provide a mechanism to address effectively any deficient performance.

The two-tiered management system called for an overall assessment of individual performance, which would be rated either "Acceptable" or "Unacceptable" based on performance in several critical elements that were standard across the SEC and based on identified agency Success Factors.

To link performance with compensation, the process allowed for five different levels of performance to be recognized, and only employees who receive an "Acceptable" assessment would be eligible for – although not guaranteed – a merit increase. Employees receiving an "Acceptable" assessment would receive either 0, 1, 2 or 3 merit steps depending on a determination by management of appropriateness.

In developing this system, the SEC solicited employee concerns through studies, employee surveys, and employee focus groups. Our efforts were informed by the results of these SEC sponsored assessments as well as assessments of SEC and other federal agencies such as the Office of Personnel Management (OPM), the Government Accountability Office (GAO), and OMB.

September 2007 Arbitration Decision

After the first merit pay cycle in 2003, the NTEU filed a grievance against the merit pay process alleging that it discriminated against employees in several protected classes. The Commission received the arbitrator's decision in this case on September 4, 2007. Although the Arbitrator ruled that the statistical evidence concerning the Commission's compensation system in 2003 supported a finding of impact discrimination in two of those classes – black employees in pay grades 8 to 16 and employees age 40 and over – the arbitrator's ruling made clear that there was no evidence of any intentional discrimination on the part of the Commission or any of its employees.

The arbitrator did not make a ruling on the appropriate remedy, and asked that the parties present briefs on how to resolve the issue. The briefs have been submitted to the arbitrator and briefing on all issues should be complete this month. We await the arbitrator's decision. Without waiving our rights as to the arbitrator's liability finding, the Commission has filed a brief that proposes a remedy that would make whole affected employees consistent with the Commission's commitment to a pay-for-performance system. The Commission's brief proposes that, for all employees in the two impacted classes, the Commission would individually reconsider the merit pay awards for 2003 with a goal of more fully rewarding employee contributions to the Commission's mission. Retroactive pay adjustments would be made to employees who receive upgraded awards. The NTEU would be provided a summary of the pay adjustments, and individual employees who remain dissatisfied would be permitted to file grievances in accordance with the collective bargaining agreement. We continue to work through this legal process.

Five-Tiered Performance Management Program

Even before the arbitrator's ruling, the SEC had identified a number of areas where the two-tiered system could be improved. A hallmark of SEC management's approach in this area has been continual review and reassessment to correct any shortcomings that have been identified. The SEC remains committed to improvement in both its pay-for-performance system and performance management program, and is in the process of building on our experience with revisions designed to strengthen the agency's ability to assess individual and team performance.

In September 2006, the Commission established the Performance and Accountability Branch within the Office of Human Resources (OHR). This branch is charged with further improving the performance management process while strengthening the link between performance and compensation.

Currently, this branch is leading the implementation of a new, five-tiered performance management program for the Commission that will help establish unambiguous criteria from which fair, credible, and transparent rating and merit increase decisions can be made. The five-tiered program replaces the system that was the subject of the arbitration dispute. The five-tiered program is essential for making meaningful distinctions in performance among our employees, and responds to concerns for a more equitable system. It was designed specifically for the Commission's unique business needs by SEC subject-matter experts and a consulting firm widely recognized as leading in the areas of performance management and measures. A joint Labor-Management Team comprised of senior OHR staff and NTEU officials is working collaboratively on our transition to this new program.

This program moves the Commission away from standardized performance elements to more individualized performance objectives and competencies, and will require supervisors to make meaningful distinctions in performance on a 5-tier scale.

This is a distinct departure from the current "pass/fail" system, and a change that will require a significant cultural shift within the Commission. Consequently, the SEC is deliberately phasing in the transition so as to allow time for adjustments that will ensure the program supports the strategic needs of the various offices and divisions.

The transition began in September 2006, with a pilot program involving all SEC OHR personnel. OHR personnel began using all new performance plans in October 2006 and completed the first annual assessment under the new program in October 2007. This was in keeping with the commitment from OHR to live with any new system for at least one year before transitioning the rest of the Commission.

Following significant adjustments based on lessons learned from the OHR pilot program and feedback from SEC managers and supervisors, the Commission's management is now being transitioned into the new system. Training begins later this month with a goal of having SEC leaders on the new program by October 1, 2008. The Commission is purposefully taking its time and starting with leadership to allow them to become comfortable with the new process before being required to manage subordinates on it. We anticipate transitioning the rest of the Commission beginning in 2009. Also the Commission has decided to temporarily separate our performance management system from the merit pay system until the new performance management system is completely implemented. This will allow the Commission to focus all of its efforts on effectively implementing all aspects of the new system before relying on it to provide performance information to support pay decisions. During this interim period, all employees receiving an "Acceptable" performance rating will receive an equivalent share of the funds the agency has available for merit pay increases.

The new performance management program was developed based on best practices both from other federal agencies and the private sector. Additionally, it responds to several performance-related recommendations from the GAO and OPM. Finally, the new program addresses issues raised by the SEC's own Office of Inspector General (OIG). To underscore the SEC's resolve to improve continuously in this area, the OIG has agreed to perform another full audit of the performance management program in two years.

Thank you for providing me the opportunity to update you on the SEC's pay-for-performance system, I would be happy to address any questions you may have.