

August 2005

# SEC AND CFTC PENALTIES

## Continued Progress Made in Collection Efforts, but Greater SEC Management Attention Is Needed



G A O

Accountability \* Integrity \* Reliability



Highlights of [GAO-05-670](#), a report to congressional requesters

## Why GAO Did This Study

The Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) impose penalties, disgorgements, and restitution on proven and alleged violators of the securities and futures laws, respectively. GAO has issued a number of previous reports on agency collection efforts and made numerous recommendations for improvement.

This report follows up on open issues from the previous reports and (1) discusses SEC's progress in improving its tracking of penalty and disgorgement collection data, (2) assesses the steps SEC has taken to improve collection program management, (3) evaluates SEC's implementation of the Fair Fund provision in the Sarbanes-Oxley Act of 2002, and (4) describes CFTC's actions to address previous GAO recommendations.

## What GAO Recommends

In this report, GAO makes six recommendations to SEC, three of which are designed to ensure that collection staff members have the necessary tools and support and are used effectively, and the other three are designed to ensure that SEC's collection program meets its goal of deterring securities law violations and returning funds to harmed investors. SEC agreed with these recommendations.

[www.gao.gov/cgi-bin/getrpt?GAO-05-670](http://www.gao.gov/cgi-bin/getrpt?GAO-05-670).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Richard J. Hillman at (202) 512-8678 or [hillmanr@gao.gov](mailto:hillmanr@gao.gov).

# SEC AND CFTC PENALTIES

## Continued Progress Made in Collection Efforts, but Greater SEC Management Attention Is Needed

### What GAO Found

In response to GAO's previous recommendations, SEC has taken positive steps to improve its tracking of collection data, such as discontinuing its use of an unreliable tracking system, modifying its existing Case Activity Tracking System (CATS) to capture financial data, and establishing a policy for improved data entry. GAO's review of 45 cases tracked in CATS revealed that SEC complied with its policy for improved data entry, a step that contributes to improving the overall reliability of SEC's collection data. However, GAO identified additional actions that SEC can take to enhance CATS's usefulness for key users, such as attorneys, collection monitors, and case management specialists in the Division of Enforcement. SEC is currently addressing this issue through a multiyear effort to comprehensively upgrade CATS. Agency officials estimate that the upgrade, which will be completed in phases, will be fully complete in 2008.

SEC has also addressed some previous recommendations made to strengthen management of its collection program, such as increasing its collection staff and referring eligible delinquent cases to the Department of the Treasury's (Treasury) Financial Management Service (FMS) on a timely basis. However, SEC must take further steps to address other recommendations designed to enhance management's evaluation of program performance. During this review, GAO identified new issues that warrant SEC management attention. For example, although SEC has increased the number of staff devoted to collection efforts, the agency has neither developed a method to ensure that adequate and consistent supervision is provided to them, nor has it formally assessed whether its additional resources are being used effectively. SEC also has not developed a procedure by which to ensure that two key units, both responsible for tracking collection activity, are effectively communicating and coordinating with one another.

Since implementing Section 308(a) of the Sarbanes-Oxley Act of 2002, (commonly known as the Fair Fund provision), SEC has instructed its staff to aggressively use the provision and estimates designating over \$4.8 billion for return to harmed investors as a result of the provision's enactment. However, to date, only a small amount of the funds have been distributed. According to SEC, distribution is often a lengthy process that can be further complicated by external factors such as a pending criminal indictment on the violator. GAO also found that SEC lacked a reliable method by which to identify and collect data on Fair Fund cases. SEC took action to address this issue, but efforts were still in their early stages. SEC has yet to analyze the data it has collected in order to fully determine the provision's effectiveness in returning an increased fund amount to harmed investors.

CFTC implemented both recommendations from previous GAO reports related to controls over fingerprinting procedures and timely referral of eligible delinquent cases to Treasury's FMS.

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**Abbreviations**

CATS	Case Activity Tracking System
CFTC	Commodity Futures Trading Commission
CMP	civil monetary penalties
CMS	case management specialist
DCIA	Debt Collection Improvement Act of 1996
DPTS	Disgorgement Payment Tracking System
FBI	Federal Bureau of Investigation
FMS	Financial Management Service
GAAP	generally accepted accounting principles
MUI	Matters Under Inquiry
NASD	National Association of Securities Dealers
NFA	National Futures Association
NYSE	New York Stock Exchange
OCIE	Office of Compliance Inspections and Examinations
OIG	Office of Inspector General
OIT	Office of Information Technology
OMB	Office of Management and Budget
OFM	Office of Financial Management
PCA	Private Collection Agency
SEC	Securities and Exchange Commission
SOX	Sarbanes-Oxley Act of 2002
SRO	self-regulatory organizations
TOP	Treasury Offset Program

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United States Government Accountability Office  
Washington, D.C. 20548

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August 31, 2005

The Honorable John D. Dingell  
Ranking Minority Member  
Committee on Energy and Commerce  
House of Representatives

The Honorable Barney Frank  
Ranking Minority Member  
Committee on Financial Services  
House of Representatives

The Honorable Paul E. Kanjorski  
Ranking Minority Member  
Subcommittee on Capital Markets, Insurance,  
and Government Sponsored Enterprises  
Committee on Financial Services  
House of Representatives

The Securities and Exchange Commission's (SEC) primary mission is to protect investors and maintain the integrity of the securities markets. Similarly, the Commodity Futures Trading Commission (CFTC) protects market users and the public from fraud, manipulation, and abusive practices related to the sale of certain commodity interests, including futures and options. As a part of their responsibility to protect investors, the agencies seek to ensure that individuals who violate federal securities or futures laws and regulations take responsibility for their misdeeds.<sup>1</sup> For their enforcement actions to be successful, however, both agencies must have collection and distribution programs that function effectively.

In 2002, Congress passed the Sarbanes-Oxley Act (SOX) to address corporate malfeasance and restore investor confidence in the U.S. securities markets. This legislation established numerous reforms to increase investor protection, including Section 308(a), the Federal Account for Investor Restitution provision, commonly known as the Fair Fund provision. This provision allows SEC to combine civil monetary penalties (CMP) and disgorgement amounts collected in enforcement cases to

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<sup>1</sup>For purposes of this report, the term "securities law" has the meaning as ascribed to such term in Section 3(a)(47) of the Securities Exchange Act of 1934, as amended, and the term "futures laws" refers to the Commodity Exchange Act, as amended.

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establish a fund for the benefit of victims of securities law violations. Disgorgement is a remedy designed to deprive defendants of their ill-gotten gains derived from their illegal activities. Before the law was implemented, any CMPs collected were remitted directly to the Department of the Treasury (Treasury), and only the amount of the actual disgorgement was available to establish a fund for the benefit of victims. The new provision reinforces the need for SEC to have an effective collection and distribution program for both CMPs and disgorgement so that additional funds collected as a result of the Fair Fund provision can benefit harmed investors.

GAO has issued a number of reports, including follow-up reports, on SEC and CFTC's collection efforts and has made numerous recommendations designed to help the agencies optimize their collection programs.<sup>2</sup> Our previous studies have shown that each agency continues to make refinements and improvements in many areas but that some recommendations designed to further strengthen their collection efforts remained open. This study, responds to your requests that we reexamine SEC and CFTC's actions to address 12 recommendations that remained open from prior studies, but focuses primarily on SEC's activities because SEC handles significantly more cases than CFTC and had the majority of open recommendations. Specifically, this report (1) discusses SEC's progress in addressing recommendations aimed at improving the tracking of penalty and disgorgement collection data, (2) assesses the steps SEC has taken to address recommendations on its management of the collection program and other related issues, (3) evaluates SEC's implementation of the Fair Fund provision, and (4) describes the actions CFTC has taken to address previous recommendations.

To evaluate SEC and CFTC's efforts to enhance their tracking of collection data, we conducted a case file review at SEC to test the accuracy and completeness of their data and reviewed CFTC's process for tracking and managing its data. To obtain additional insight into each agency's collection

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<sup>2</sup>GAO, *SEC and CFTC Fines Follow-up: Collection Programs Are Improving, but Further Steps are Warranted*, [GAO-03-795](#) (Washington, D.C.: July 15, 2003); *SEC Enforcement: More Actions Needed to Improve Oversight of Disgorgement Collections*, [GAO-02-771](#) (Washington, D.C.: July 12, 2002); *SEC and CFTC: Most Fines Collected, but Improvements Needed in the Use of Treasury's Collection Service*, [GAO-01-900](#) (Washington, D.C.: July 16, 2001); *Money Penalties: Securities and Futures Regulators Collect Many Fines but Need to Better Use Industrywide Data*, [GAO/GGD-99-8](#) (Washington, D.C.: Nov. 2, 1998); and *Securities Enforcement: Improvements Needed in SEC Controls Over Disgorgement Cases*, [GAO/GGD-94-188](#) (Washington, D.C.: Aug. 23, 1994).

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program, we reviewed pertinent documents, including flowcharts, collection guidelines, position descriptions, court dockets, computer-generated documents, memorandums of understanding, and related laws. Further, we interviewed the appropriate management and staff members at SEC and CFTC on their respective agency's collection and data tracking processes. We also obtained and reviewed documents on delinquent case referrals from Treasury's Financial Management Services (FMS). To assess SEC's efforts regarding performance measures and oversight of self-regulatory organizations (SRO) and SEC and CFTC's fingerprinting initiatives, we interviewed key officials at both agencies regarding actions they were taking to address the weaknesses identified and reviewed relevant documents. In regard to the Fair Fund provision in SOX, we obtained relevant documentation and discussed SEC's implementation approach with the appropriate officials. To calculate each agency's penalty and disgorgement collection rate, we obtained information on monies ordered and collected from SEC and CFTC for the period beginning September 1, 2002, and ending December 31, 2004. We conducted our work from August 2004 to August 2005 in Washington, D.C., in accordance with generally accepted government auditing standards. Appendix I describes the objectives, scope, and methodology of our review in more detail.

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## Background

SEC was created in 1934 to protect investors and maintain the integrity of the securities market. To accomplish its mission, the agency established four strategic goals: (1) to enforce compliance with federal securities laws, (2) to sustain an effective and flexible regulatory environment, (3) to encourage and promote informed investment decision making, and (4) to maximize the use of SEC's resources.

CFTC, established in 1974, performs a comparable role in the futures industry. Its primary mission is to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity futures and options and to foster open, competitive, and financially sound commodity futures and options markets. CFTC has set three strategic goals to support its mission: (1) to ensure the economic vitality of the commodity futures and option markets; (2) to protect market users and the public; and (3) to ensure market integrity in order to foster open, competitive, and financially sound markets.

Both SEC and CFTC are independent agencies that have five-member presidentially-appointed commissions that are led by chairmen who are

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designated by the President. SEC and CFTC's headquarters are located in Washington, D.C.; SEC has a combination of 11 regional and district offices; CFTC has 5 regional offices.

In keeping with its mission, each agency has a regulatory responsibility to protect investors by ensuring the integrity of the securities and commodity futures markets. Once SEC or CFTC staff conducts an investigation and determines that a person or company has violated the law and should be charged, the agency authorizes a civil suit against the alleged violator in federal district court or a proceeding before an administrative law judge. On finding that a defendant has violated securities or futures laws, the court or the administrative law judge can issue a judgment ordering sanctions such as CMPs, disgorgement, and/or restitution.<sup>3</sup> However, the agencies may decide not to seek disgorgement or restitution because it is found to be unwarranted—for example, if a violator did not make a profit from the illegal activity. Table 1 provides more information on some of the remedies available to a federal district court or an administrative law judge.

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<sup>3</sup>A judgment is a ruling on how much the violator should pay as a result of their misdeeds. CMPs are based on the “level of egregiousness” of the underlying conduct and the violator’s ability to pay. Disgorgement and restitution are based, respectively, on the extent to which the wrongdoer profited, and the victim lost as a result of the violations, and do not take into account ability to pay.

**Table 1: Types of Remedies Available for SEC and CFTC Violations**

Remedy	Available to SEC	Available to CFTC
<b>Civil monetary penalty:</b> A remedial measure aimed at deterring future misconduct.	X	X
<b>Disgorgement:</b> An equitable remedy aimed at preventing a wrongdoer from unjustly enriching himself from his wrongs; deprives violators of “ill-gotten gains” linked to the wrongdoing. SEC/CFTC do not have to prove an exact amount but must show the estimate is reasonable.	X	X
<b>Disgorgement Fund:</b> A fund created for the benefit of harmed investors from the collection of a disgorgement order imposed on a securities law violator. If a disgorgement fund is not created, the proceeds from disgorgement are remitted to the Treasury.	X	X
<b>Fair Fund:</b> A disgorgement fund that also includes a civil monetary penalty imposed on the disgorged violator.	X	
<b>Restitution:</b> An equitable remedy to attempt to make the victims whole. Requires proof of specific damages to the victims.	X <sup>a</sup>	X
<b>Reparation:</b> A compensatory award to harmed investors in a private proceeding before CFTC hearing officials.		X

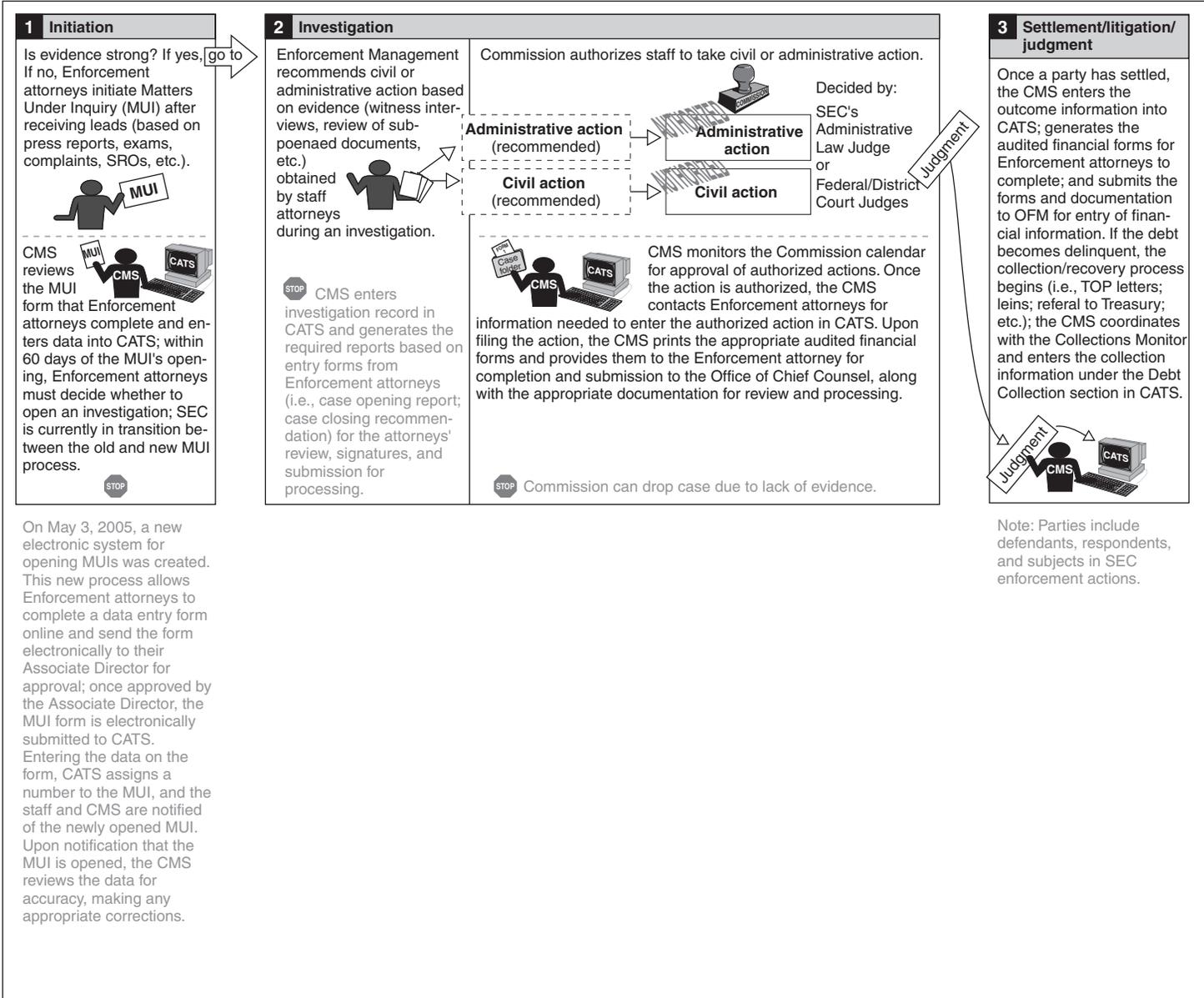
Sources: GAO analysis of SEC and CFTC data.

<sup>a</sup>Although restitution is available to SEC, the agency typically imposes CMPs and disgorgement.

SEC and CFTC both have collection programs and designated staff to track, collect, and manage CMPs and disgorgement or restitution orders. Specifically, as shown in figure 1, staff in SEC’s Division of Enforcement (Enforcement) use the Case Activity Tracking System (CATS) to track investigations, enforcement actions, and matters under inquiry (issues that have the potential to turn into investigations).<sup>4</sup>

<sup>4</sup>CATS is not integrated with other databases at SEC but serves as a source of data for an agencywide search engine that staff use to perform searches on individuals or companies under investigation.

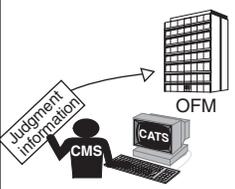
**Figure 1: Overview of SEC's Case Tracking Process**



Source: GAO analysis of SEC's case tracking process.

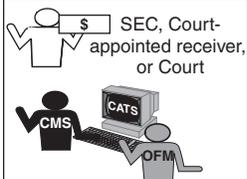
**4 Tracking monies ordered and collected**

CMS sends copy of Form 2 and documentation for each party to OFM for entry into CATS. Once OFM has entered the information, CMS checks for accuracy. If the record is accurate, the CATS screens are printed and added to the file. If errors are found, OFM is notified and asked to correct the entries.



**5 Collection/enforcement**

**A Money collected**



- Money goes to SEC/Treasury or third-party receiver for distribution to harmed investor, or to court registry.
- If payment comes to SEC, OFM logs receipt of payment in cash receipt log.
- Separate OFM staff person enters payment from cash receipt log into money paid field of CATS.
- Attorney makes decision on whether to close case (or keep it open due to unrelated circumstances).
- Enforcement staff manages the closeout process in CATS.

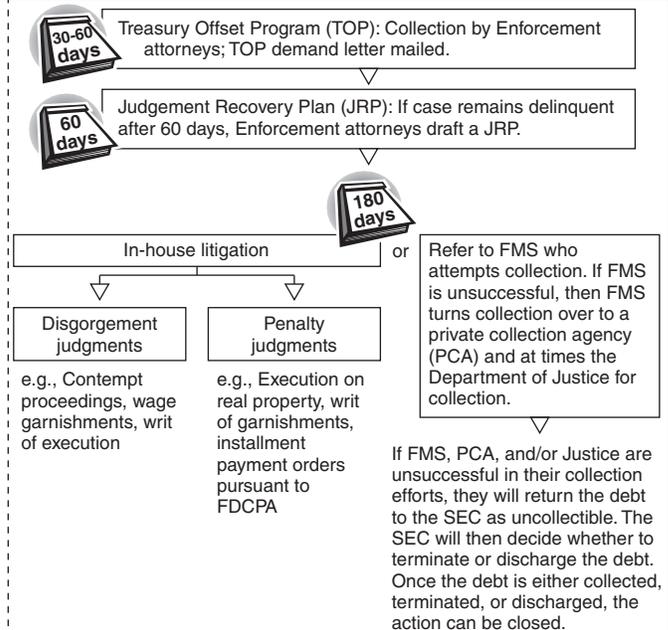


**B Delinquent**

Case referred to Collection Monitor (CM) 5 days after delinquency (case becomes delinquent if not paid by due date, which is typically 10 days after the judgment/money is ordered).



Collection activities cease once money is paid.



If FMS, PCA, and/or Justice are unsuccessful in their collection efforts, they will return the debt to the SEC as uncollectible. The SEC will then decide whether to terminate or discharge the debt. Once the debt is either collected, terminated, or discharged, the action can be closed.

**6 Distribution of collected funds**

SEC staff, or an external designee (e.g., a receiver), develops the distribution plan.

- Typical steps in the distribution process:
- Identify harmed parties.
  - Draft distribution plan.
  - Allow time for comments from Court, Commission, and/or defendants.
  - Publish plan.
  - Invite claims.
  - Review and categorize claims.
  - Distribute collected funds based on the amounts of the claimed losses.



**7 Case closed (or attorney maintains "open" status until all issues are resolved)**



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When a case has been delinquent for at least 10 days, SEC and CFTC staff can send a demand letter to a violator. The Debt Collection Improvement Act of 1996 (DCIA)<sup>5</sup> requires all federal agencies, including SEC and CFTC, to refer non-tax debt more than 180 days delinquent to the Secretary of the Treasury for purposes of centralized administrative offset. Once such a referral is received, Treasury's FMS activates the Treasury Offset Program (TOP), under which outstanding debts, including amounts due to SEC or CFTC as a result of judgments or settlement agreements, are collected by the withholding of federal payments that the government owes the debtor, such as tax refunds.<sup>6</sup> During its collection efforts, FMS may negotiate compromise offers with debtors unable to pay the entire amount of a judgment and may accept less than the full amount if doing so is the only way to ensure that the violator pays at least some of the debt owed.<sup>7</sup> SEC and CFTC must approve such offers for violators under their purview and may reject an offer or ask for further information if the supporting documentation is not satisfactory.

In general, when a disgorgement fund is established, SEC attorneys can propose appointing a receiver to develop and administer a distribution plan to facilitate the collection of disgorgement and, in the case of Fair Funds, both CMPs and disgorgement, and the distribution of those funds to harmed investors.<sup>8</sup> Receivers act independently of SEC and defendants in conducting their prescribed duties. They have primary responsibility for establishing the distribution plan, including a description of the actions that will be taken to identify harmed investors, and for ensuring that the appropriate taxes are deducted from the monies collected.

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<sup>5</sup>Pub. L. No. 104-134. Title III. Ch. 10. 110 Stat. 1321-358 (Apr. 26, 1996).

<sup>6</sup>31 U.S.C. § 3716(c)(6); 31 C.F.R. § 901.3(b). With some exceptions, agencies are also required to transfer all non-tax debts over 180 days delinquent to FMS for purposes of debt collection. Administrative offset is one type of tool used for collection, therefore, the transferring of the debt simultaneously satisfies the referral requirement for purposes of an administrative offset. 31 C.F.R. § 285.12(g).

<sup>7</sup>In many instances, the financial circumstances of violators make it unlikely that they will be able to pay the full amount of a judgment—for instance, some violators are jailed and are thus unable to generate income, while others may have filed for bankruptcy.

<sup>8</sup>Receivers can be appointed at any stage of the litigation process by the court to perform duties such as identifying and seizing assets but may also be appointed for the sole purpose of developing and administering the distribution plan.

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Before Congress passed SOX, SEC could return only funds collected from disgorgement to persons who had suffered financial harm from securities violations. However, Section 308 (a) of the act allows SEC to add CMPs to disgorgement funds. Section 308 (c) of the act also requires SEC to report on the approaches the agency used, before the Fair Fund provision, to (1) provide compensation to harmed investors and (2) to improve the collection rates for CMPs and disgorgement, in order to establish a benchmark for further action.

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## Results in Brief

SEC has made a variety of improvements to its system for tracking data on penalty and disgorgement collections, consistent with our previous two recommendations. However, the agency could take additional actions to improve its financial reporting controls and the usefulness of its system for key users. Since our last report in 2003, SEC has stopped using an unreliable tracking system, modified CATS to capture penalty and disgorgement financial data, and established and implemented a policy designed to make data entry into CATS more accurate. Although SEC has made progress in addressing data reliability concerns we had in the past, it must take additional steps to improve inadequate controls in the recording and reporting of penalty and disgorgement transactions, as discussed in our recent audit of SEC's financial statements for fiscal year 2004.<sup>9</sup> SEC plans to strengthen internal controls and policies over its existing recording and reporting process and is beginning a multiyear project to replace CATS. Furthermore, we found—and SEC agreed—that it could take additional action to ensure that CATS better meets the needs of key users, such as attorneys and other collection staff. The agency is in the process of upgrading CATS to address the needs of a broader range of users, and expects the project to be complete in 2008.

SEC has taken actions addressing five open recommendations made in prior studies that were designed to improve some collection activities but has not fully addressed three remaining recommendations regarding management's evaluation of program performance. Specifically, SEC has

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<sup>9</sup>In GAO, *Financial Audit: SEC's Financial Statement for Fiscal Year 2004*, [GAO-05-244](#) (Washington, D.C.: June 25, 2005), we identified inadequate controls in the recording and reporting of penalty and disgorgement information related to manual procedures that SEC employed in transferring penalty and disgorgement data from CATS to subsidiary accounting ledgers. For this report, our assessment of the steps SEC has taken to improve the tracking of penalties and disgorgement focused on those designed to ensure the reliability of the initial data entered into CATS.

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(1) referred eligible delinquent cases to FMS in a more timely manner, (2) established controls for fingerprinting procedures to help prevent inappropriate persons from being admitted to the securities industry, (3) begun to review the consistency of disciplinary actions taken by SROs, (4) made more timely decisions on compromise offers, and (5) increased the number of staff devoted to ensuring timely and successful collection efforts.<sup>10</sup> However, SEC is still working to address one long-standing open recommendation related to improving the tracking of the amounts of disgorgement ordered, collected, and distributed, and the appropriateness of receiver fees on both an aggregate and individual basis. During this review, we found that SEC had recently expanded its CATS database to begin capturing the necessary information but had yet to centrally monitor subsequent distribution activities. Similarly, SEC has not fully addressed an open recommendation that it implement alternative performance measures for evaluating its overall collection program. The agency continues to rely on its collection rate as a measure of success; however, SEC itself acknowledges this measure does not effectively demonstrate the effectiveness of its collection program. The collection rate can be significantly affected by factors such as the agency's success or failure to collect on a few large cases. In addition, SEC has responded to an earlier recommendation by establishing policies and procedures to provide collection staff with guidance on the type, timing, and frequency of collection activities they should follow. Despite this, the agency has not effectively monitored staff's implementation of these guidelines, partly because collection staff in regional offices have been supervised by regional managers who are not always familiar with the collection process. As a result, SEC management cannot readily determine whether sufficient and appropriate collection efforts are being made. Finally, we identified new concerns related to some of the changes SEC had made to its collection program. First, SEC does not have a formal mechanism to assess whether its additional collection resources are being used effectively. Although SEC management believes that the new resources have alleviated the need for staff attorneys to do some of the administrative duties related to collections, SEC cannot validate such benefits without more formal evaluation. SEC staff said that they plan to direct more attention to this issue once the collection program becomes more stabilized after a year of

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<sup>10</sup>In addition to SEC and CFTC oversight, the U.S. securities and futures markets are regulated under their respective statutes by SROs, which include the New York Stock Exchange (NYSE), American Stock Exchange, National Association of Securities Dealers (NASD), Chicago Board of Trade, Chicago Mercantile Exchange, and National Futures Association (NFA), among others.

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changes made in preparation for the agency's first external financial audit. Second, some of the collection staff pointed to the need for management to provide them with more guidance or training on new collection procedures and data entry protocols to help them better perform their duties and thus improve the program's effectiveness. Third, we found that the two SEC units that are responsible for tracking and maintaining the collection data in CATS did not always communicate and coordinate with one another on a timely basis, potentially leading to inefficiencies that could affect the collection process.

We also found that while SEC emphasizes its commitment to implementing the Fair Fund provision of SOX, the agency has not formally assessed the impact of the provision. In particular, SEC staff demonstrated support for the provision by promoting an aggressive approach in seeking, where appropriate, disgorgement orders in cases where CMPs are also being sought. For example, attorneys have obtained disgorgement for as little as \$1 in settlements in order to obtain authorization from the SEC Commission to create a Fair Fund. SEC estimates that, as of April 2005, it had designated over \$4.8 billion in CMPs and disgorgement to be returned to harmed investors. Nevertheless, SEC did not have a reliable method to identify these monies because CATS predates the Fair Fund provision and thus cannot readily identify Fair Fund cases or collect related data. A lack of reliable and meaningful data could hinder SEC's ability to (1) ensure that the maximum amount possible is returned to harmed investors and (2) develop effective measures of the program's success. SEC recognizes the need to track Fair Fund data and has recently added fields to CATS to identify these cases and track their distribution. Finally, as required by SOX, SEC has issued a report on actions it has taken to collect funds to be returned to harmed investors and methods it has used to maximize investor recovery.

As part of this review, we also found that CFTC implemented actions that were consistent with the two remaining recommendations in our 2003 and 2001 reports. Specifically, we determined that CFTC, like SEC and consistent with our 2003 recommendation, had participated with other securities and futures regulators in initiatives designed to improve controls over fingerprinting procedures for applicants seeking admission to the futures industry. Further, CFTC has also developed a process for referring eligible delinquent cases to FMS on a timely basis, as we recommended in our 2001 report.

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This report includes six new recommendations to the SEC Chairman to ensure that SEC's collection staff have the appropriate tools to carry out their duties and to improve SEC's ability to manage its collection program. We requested comments on a draft of this report from the Chairmen, SEC, and CFTC. SEC provided written comments that are reprinted in appendix III. SEC agreed with all of our recommendations and plans to take action to address them. SEC's comments are discussed in more detail at the end of this report. CFTC provided technical comments, as did SEC, which have been incorporated where appropriate.

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## **SEC Has Made Progress in Improving the Accuracy and Usefulness of Data It Collects, but Continued Attention Is Needed**

Our previous reports contained two recommendations that remained open related to SEC's tracking of collection data. First, in 2002, we recommended that SEC develop appropriate procedures to ensure the accuracy and timeliness of information maintained in the Disgorgement Payment Tracking System (DPTS), which was the tracking system SEC used at the time to monitor disgorgement that had been ordered, waived, or collected. Second, in 2003, we recommended that SEC take the steps necessary to implement an action plan to replace DPTS with a new and improved collection tracking system. SEC has made progress in addressing these two recommendations by discontinuing its use of DPTS, modifying CATS to capture financial information, and establishing an improved procedure for entering data into CATS. Nevertheless, our fiscal year 2004 audit of SEC's financial statements disclosed inadequate internal controls over its reporting of penalty and disgorgement transactions. SEC plans to address this finding by strengthening its policies and its internal controls over existing processes. In addition, we found, and SEC agreed that opportunities exist to improve CATS's usefulness. The agency is in the process of upgrading CATS to address the needs of a broader range of users, but the project is in its early stages. Agency staff estimate that it will not be fully complete until 2008.

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## **SEC Discontinued DPTS, Modified CATS, and Established a Policy to Improve Tracking of Collection Data**

In 2002, we reported that weaknesses in SEC's procedures for entering and updating data in DPTS resulted in the system containing unreliable data. Our 2002 review of a sample of 57 enforcement cases found that 18 cases, or approximately 32 percent, contained at least one error in the amount of disgorgement ordered, waived, or collected, or in the status of the case or of the individual violators. We found that the sources used as a basis for entering data into DPTS did not always provide the most accurate information. For example, we reported that staff in SEC's Office of the

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Secretary, who were responsible for entering data into DPTS, relied heavily on SEC litigation releases that, according to the staff, did not contain all the details of a disgorgement order. The staff also said that they did not independently verify the information in the litigation releases. In January 2003, an independent accountant confirmed that information in DPTS was not current and complete and reported that the system could not be relied upon for financial accounting and reporting purposes.<sup>11</sup> As of October 2003, SEC discontinued its use of DPTS.

SEC began using CATS to capture the financial information that DTPS had tracked. This change was part of larger modifications to CATS made in response to a legislative requirement that SEC prepare audited financial statements for submission to Congress and the Office of Management and Budget (OMB). SEC modified CATS by adding fields to capture the necessary financial data—such as the amount of CMPs and disgorgement ordered, collected, and distributed—and established a policy of entering data on the amount of disgorgement and CMPs only if valid supporting documentation was available.<sup>12</sup> SEC staff said they began collecting original source documents—copies of signed and stamped final judgments, administrative orders, and court dockets—from SEC’s headquarters, regional, and district offices. SEC staff also told us that they entered financial data only for those cases with an open enforcement action as of October 1, 2002, the beginning of fiscal year 2003.<sup>13</sup> As of February 2005, SEC staff said that they had entered data on almost all of the approximately 4,500 enforcement cases, which involved over 12,000 defendants and respondents that met SEC’s criterion.

We reviewed a sample of 45 cases tracked in CATS and determined that SEC had complied with its policy for improving data entry, which is

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<sup>11</sup>U.S. Securities and Exchange Commission’s Office of Inspector General, *Financial Management Systems Controls: Independent Accountant’s Report*. Audit No. 362, (Washington, D.C.: Jan. 31, 2003).

<sup>12</sup>As a result of the enactment of the Accountability of Tax Dollars Act of 2002, SEC is required to prepare and submit to Congress and OMB audited financial statements. 31 U.S.C. § 3515. Fiscal year 2004 was the first year SEC prepared its first complete set of financial statements pursuant to this requirement.

<sup>13</sup>An enforcement action occurs when SEC files a complaint against an alleged violator of federal securities laws in federal district court or before an administrative law judge.

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consistent with our previous recommendation.<sup>14</sup> Specifically, we found supporting source documents for each of the 45 case files we reviewed and were able to compare information from the source documents with the data in CATS (as reflected in a March 2005 printout). However, our comparison identified one \$300,000 discrepancy on the amount of disgorgement ordered and entered in CATS.

Although SEC has made progress in improving the reliability of CATS collection data, in May 2005, we reported that SEC had inadequate controls over its penalty and disgorgement activities, which increased the risk that such activities would not be completely, accurately, and properly recorded and reported for management's use in decision making.<sup>15</sup> In response to our findings, SEC stated that the agency plans to strengthen internal controls and policies over its existing recording and reporting process and has begun a multiyear project to upgrade CATS.

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## Opportunities Exist to Improve CATS's Usefulness

During this review, we found—and SEC agrees—that opportunities exist to further improve CATS's usefulness for key system users, including attorneys, case management specialists, and collection monitors in Enforcement. Specifically, we found that CATS does not allow the attorneys in Enforcement to perform customized searches or generate tailored reports on the status of their cases. According to SEC staff, certain search and reporting capabilities are available to a handful of management level staff in the division but not to attorneys, who constitute the bulk of the division's workforce. By not meeting the attorneys' needs, CATS does not allow SEC to fully leverage its existing resources, and attorneys are not able to efficiently address their multiple and sometimes competing investigation, litigation, and collection duties.

Similarly, we found that CATS currently does not meet all the needs of case management specialists and collection monitors. Some staff, whose positions were recently established to better track and report collection activities, have expressed concerns about CATS's limited reporting and search capabilities. To compensate for these limitations, we found that collection staff in each of SEC's headquarters, district, and regional offices

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<sup>14</sup>We selected and examined data for only one individual defendant or respondent within a case. One case can have multiple defendants and respondents.

<sup>15</sup>[GAO-05-244](#).

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are using their own ad hoc collection database—outside of and separate from CATS—to track the status of delinquent cases. According to the collection staff, these databases allow for faster reporting and retrieval of information than CATS but, because they also require the staff to enter some data twice, using additional databases could lead to inefficiencies.

To address the various concerns of key users, including attorneys, case management specialists, and collection monitors, and to strengthen the inadequate internal controls identified in the 2004 financial statement audit, SEC has begun a multiyear effort to upgrade CATS. SEC staff said that they are trying to transform what is essentially a case tracking system into a case management system that would be useful to a broader range of users. For example, as part of the upgrade effort, SEC is seeking to allow attorneys to generate customized reports on their cases, search for information in memorandums, and establish a system that would notify staff and remind them of deadlines in their cases. According to SEC's Office of Information and Technology, the upgraded system is also expected to address the needs of case management specialists and collection monitors by capturing and reporting data they require, eliminating the need for the separate databases. In December 2004, SEC released a draft requirements analysis for the upgraded system that contained steps to address the concerns of SEC's user community. SEC approved funding for the first phase of the project in June 2005 and, according to staff, the project will be fully complete in 2008.

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## **SEC Has Made Progress in Managing Its Collection Program but Needs to Take Further Steps**

SEC has taken actions consistent with five of eight open recommendations from our previous studies (table 2). The open recommendations that SEC addressed were aimed at improving collection activities—for example, SEC's practices for referring delinquent cases to FMS—and addressing the need for additional collection resources. However, further actions are needed to fully address three remaining open recommendations, which are designed to improve SEC's performance measures and program evaluations. Moreover, we identified three new concerns related to SEC's management of collection staff, including (1) the lack of a formal process for assessing the impact of collection staff efforts, (2) the need for additional routine training and guidance to ensure the effectiveness of collection staff's efforts, and (3) the need for more formal communication and coordination protocols between the two units that track and maintain CATS data in order to improve the efficiency of collection activities.

## SEC Has Taken Actions to Improve Some Collection Activities

Our review indicated that, since 2003, SEC has made more timely referral of delinquent cases to FMS and developed a strategy for referring pre-guideline cases—that is, cases that existed at SEC before Enforcement implemented its internal collection guidelines in 2002. The agency has also worked with the SROs to establish fingerprinting guidelines and has begun analyzing data on SROs’ sanctions. In addition, SEC has worked to ensure that the agency makes timely decisions on compromise offers presented by FMS and has increased the resources for handling collections and related tasks.

**Table 2: Status of Recommendations Related to SEC’s Management of its Collection Program from 1998 to 2003 GAO reports**

Previous open recommendations	Status	
	Addressed	Not fully addressed
The SEC Chairman should:		
Develop a formal strategy for referring pre-guidelines cases to FMS and TOP that prioritizes cases based on collectability and establishes implementation time frames.	X	
Address weaknesses in controls over fingerprinting procedures that could allow inappropriate persons to be admitted to the securities industry.	X	
Analyze data collected on the SROs' disciplinary programs and establish a time frame for implementing the new disciplinary database that is to replace the current one.	X	
Continue working with FMS to ensure that compromise offers are approved in a timely manner.	X	
Complete the evaluation of options for addressing the competing priorities and increasing workload faced by SEC’s Enforcement staff, including (1) assessing the feasibility of contracting certain collection functions and (2) increasing the number of staff devoted to collections.	X	
Ensure that management uses information on the distribution of disgorgement, including the amounts due to and received by investors and the fees paid to receivers, to monitor the distribution of disgorgement.		X
Ensure that disgorgement and the collection of disgorgement are addressed in SEC’s strategic and annual performance plan, including developing appropriate performance measures.		X
Ensure the prompt implementation of collection guidelines that specify the various collection actions available, explain when such activities should be considered, and stipulate how frequently they should be performed, and develop controls to ensure that staff follow these guidelines.		X

Sources: GAO and SEC.

Note: For further information, see [GAO-03-795](#), [GAO-02-771](#), [GAO-01-900](#), and [GAO/GGD-99-8](#).

## SEC Refers Delinquent and Pre-Guideline Cases to FMS on a Timely Basis

Our 2001 report found that SEC staff lacked clear procedures to follow when referring delinquent cases to FMS for collection, as required by the DCIA. As a result, eligible delinquent debts were not promptly being referred to FMS, in turn hampering FMS’s efforts to collect on SEC’s behalf.

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In 2003, Enforcement implemented procedures to ensure more timely referrals of delinquent cases, but not enough time had elapsed at the time of our 2003 study to evaluate the effectiveness of the new procedures. However, during this review, we did find that SEC was making referrals to FMS before the 180 day time frame expired. Specifically, from a random sample of 45 cases, we identified and reviewed 6 delinquent cases that were eligible for referral and were able to verify that SEC had referred each of those cases before the 180 day limit.<sup>16</sup>

Our 2003 study also found that SEC staff had not identified a strategy for referring pre-guideline cases to FMS and did not know the extent to which the pre-guideline procedures for referring cases were being followed. We recommended that SEC staff establish a strategy that prioritized cases according to their collectability. During this review, SEC management said that all eligible delinquent cases had been referred to FMS for collection when SEC switched from tracking cases in DPTS to tracking them in CATS.<sup>17</sup> Based on our review, we determined that SEC had not prioritized the cases but had assessed all outstanding cases for possible referral to FMS and sent forward the appropriate paperwork when applicable, including for pre-guideline cases. As part of our recent review of 45 randomly selected cases, we examined the referral status of 10 pre-guideline cases and found that only one case was eligible for referral and that SEC staff had referred it to FMS before 180 days expired.<sup>18</sup>

## SEC Has Enhanced Controls for Fingerprinting Procedures

During our 2003 study, we examined the application review process for individuals seeking employment in the securities industry. During that review, we found that SEC's statute did not mandate that SROs such as NASD and NYSE require their member firms to ensure that fingerprints sent to the Federal Bureau of Investigation (FBI) as part of criminal history checks actually belonged to the applicants submitting them. Because this

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<sup>16</sup>Under SEC's internal collection guidelines, which are intended to assist the Enforcement staff in ensuring compliance with the DCIA of 1996, eligible debts that have been delinquent for more than 180 days should be prepared for referral to FMS unless (1) a case is still in litigation, (2) an entity has become defunct, (3) a defendant/respondent is deceased, incarcerated or a foreign national residing abroad, or (4) a bankruptcy is pending.

<sup>17</sup>Some SEC delinquent cases were ineligible for referral because they were on appeal, in postjudgment litigation, or had a receiver appointed to marshal and distribute assets.

<sup>18</sup>Of the remaining nine cases, three had already been collected in full; three were closed, meaning no further action was warranted; two had been terminated; and one had been waived by the court.

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lapse in oversight could have allowed inappropriate persons to enter the securities industry, we recommended that SEC establish controls to ensure that fingerprints sent by SROs to the FBI actually belong to the applicants. In July 2004, SEC and CFTC formed a task force with representatives from several of their SROs to enhance controls over existing fingerprinting guidelines. Using the FBI's guidance on the best practices for preventing fingerprinting fraud in civil and criminal cases, the task force developed a set of improved fingerprinting guidelines, including a suggestion that applicants present two forms of identification instead of one immediately before fingerprints are taken or submit an attestation form in addition to the standard U4 attestation form.<sup>19</sup> NASD made the fingerprinting guidelines available to its member firms on May 29, 2005.

#### SEC Has Begun Analyzing SROs' Disciplinary Actions

In 1998, we found that SEC was not analyzing industrywide data on disciplinary sanctions imposed by SROs to identify possible disparities that might require further review. We recommended that SEC conduct such an analysis and find ways to improve the SROs' disciplinary programs. Consistent with this recommendation, SEC developed a database to collect information on the SROs' disciplinary actions, but our 2003 study found that problems with the database were hampering SEC's ability to analyze the data. For example, the database did not capture multiple violations or multiple parties in a single case and did not support multiple users. We made a follow-on recommendation in our 2003 report that SEC analyze the data that had been collected on the SROs' disciplinary programs, address any findings that resulted from the analysis, and establish a time frame for implementing a new database.

As we recommended, SEC has begun analyzing data on disciplinary actions that the SROs took in 2003 and 2004. According to SEC staff, the analyses have shown that sanctioning practices among SROs differ primarily because the facts and circumstances of the cases vary—for instance, the number of defendants involved or presence of other violations.<sup>20</sup> SEC staff said that SEC will use the results of the analyses to determine the scope and timing of future SRO inspections. Also, as we recommended, SEC's

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<sup>19</sup>For any person seeking NASD registration, the attestation would be in addition to the attestation on the Form U4 and would require that the applicant attest to the completeness and accuracy of the information submitted on the form.

<sup>20</sup>The analyses involve the following types of violations: misrepresentation or material omissions of fact, failure to respond truthfully and completely, outside business activities, net capital violations, conversion, and continuing education requirements.

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Office of Compliance Examinations and Inspections has sought assistance from the agency's Office of Information Technology to develop a new, more reliable Web-based database that is scheduled to be deployed in September 2005. According to SEC staff, using the new database, SROs will be able to submit data to SEC online, an innovation that is expected to reduce data entry errors and increase the amount of time SEC staff have to spend on mission-related work such as inspecting SROs and examining broker-dealers. The new database is also expected to provide virtually unlimited storage capacity, improved reporting capability, and greater stability.

### SEC Has Made More Timely Decisions on Compromise Offers

In 2001, we found that SEC had not always made prompt decisions on compromise offers submitted by FMS, reducing the likelihood of collecting on the debts. At that time, we recommended that SEC continue to work with FMS to ensure that compromise offers presented by FMS were approved in a timely manner. During this study, we found that SEC had been accepting or rejecting compromise offers within 30 days of receiving them from FMS, as required by SEC's internal policy. To ensure more timely responses, SEC management assigned one staff member to monitor and track compromise offers, maintain a schedule log, and serve as a liaison with FMS to handle missing documents or other problems. According to SEC data, SEC received 12 compromise offers via e-mail between July 16, 2003, and January 6, 2005, and was able to decide on 7 of them within 30 days. The other five compromise offers were held up because of problems with missing documentation. SEC's procedures require staff to use a variety of documents in assessing compromise offers, including credit bureau reports, recent financial statements, and tax returns for the preceding 3 years. However, until early 2005, FMS did not require its staff to submit tax returns to SEC along with compromise offers. The cases that were held up at SEC because of lack of documentation all involved tax returns—in one case, the returns were illegible, and in four they were missing altogether.<sup>21</sup> On February 5, 2005, FMS issued a technical bulletin that directed staff to submit copies of tax returns for the 3 relevant years to SEC with all compromise offers. According to FMS, these new instructions should resolve any problems with missing documents and enable SEC to meet the 30-day deadline for deciding on compromise offers.

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<sup>21</sup>SEC eventually accepted the offer with the illegible tax return after receiving legible copies but rejected the remaining four offers because of the missing returns.

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## SEC Increased Its Collection Resources to Address Competing Priorities and Growing Workload

In past studies, we found that SEC's Enforcement staff attorneys, who are responsible for collecting disgorgement, had other duties and competing priorities that hindered their collection efforts. For example, depending on the office to which they were assigned, attorneys were responsible for a variety of functions, including investigating potential violations of securities law, recommending actions SEC should take when violations were found, prosecuting SEC's civil suits, negotiating settlements, and conducting collection activities for CMPs levied. We recommended in 2002 that SEC consider contracting out some collection activities and increase its collection staff. Consistent with our recommendation, in 2003 SEC assessed the feasibility of contracting with private collection agents and proposed legislative changes that would allow the agency to contact with private collection agents.<sup>22</sup> Furthermore, SEC created and filled over 20 positions, including collection attorneys, paralegals, monitors, and case management specialists in its headquarters, district, and regional offices to assist in implementing collection guidelines that the agency created in response to our 2002 recommendation that it establish such criteria, so that collections could be maximized. Below are brief descriptions of the collection staff's roles and duties:

- SEC hired three attorneys to pursue collection efforts in headquarters. These attorneys review the evidence from initial asset searches to determine whether SEC should continue with collection activities or refer the case to FMS, and they advise SEC's regional staff attorneys on their collection cases. The lead attorney also manages SEC's collection unit, develops policies (including the agency's collection guidelines), and trains staff on the collection process.
- In 2003, SEC created 13 case management specialist positions to assist attorneys with administrative tasks associated with their investigations. The specialists perform data entry tasks and track enforcement matters. Depending on the location, the number of attorneys that each specialist supports varies from smaller to larger caseloads. For example, in one region, a specialist supports 21–24 staff attorneys and in another approximately 50.

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<sup>22</sup>The feasibility assessment was part of a study done in response to SOX, SEC: *Report Pursuant to Section 308(c) of the Sarbanes Oxley Act of 2002* (Washington, D.C., January 2003). The Securities Fraud Deterrence and Investor Restitution Act was introduced in the 108<sup>th</sup> Congress as H.R. 2179 and contained provisions that, if adopted, would strengthen SEC's enforcement capabilities and assist defrauded investors. Congress has not taken action on this bill.

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- To help resolve delinquent cases, SEC also designated existing staff in each of the 11 regional offices to monitor collection activities as a collateral duty and created and filled two collection paralegal positions for headquarters.<sup>23</sup> The monitors are responsible for keeping staff and collection attorneys apprised of upcoming deadlines, assisting in referring delinquent cases to FMS, and maintaining a collection database that is separate from CATS for the Enforcement Division.

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### SEC Management Has Not Completed Actions to Evaluate the Performance of Its Collection Program

We found that SEC had made some progress in addressing our remaining three open recommendations related to (1) establishing performance measures to better track the effectiveness of SEC's collection efforts; (2) tracking, on an aggregate and individual basis, both receivers' fees and the amounts distributed to harmed investors to ensure that investor recovery is maximized; and (3) implementing collection guidelines and developing controls to ensure that staff follow the guidelines. However, as part of this review, we found that the agency could take further action on these management practices to improve these areas.

### SEC Has Established, but Not Implemented, an Alternative Performance Measure for Its Collections Activities

Under the Government Performance and Results Act, federal agencies are held accountable for achieving program results and are required to set goals and measure their performance in achieving them.<sup>24</sup> We reported in 2002 that SEC's strategic and annual performance plans did not clearly lay out the priority that disgorgement collection should receive in relation to SEC's other goals and did not include collection-related performance measures. Further, we identified several limitations in using the agency's disgorgement collection rate as a measure of the agency's effectiveness. For example, the rate is heavily influenced by SEC's success in collecting or not collecting on a few large cases and by factors that are beyond a regulator's control, such as violators' ability to pay. We suggested other measures that SEC could consider, including tracking the percentage of disgorgement funds returned to harmed investors, measuring the timeliness of various collection actions, and tracking the number of violators ordered to pay disgorgement who go on to commit other

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<sup>23</sup>According to SEC management, SEC is in the process of combining the duties of the collection monitors with those of the case management specialists.

<sup>24</sup>GAO, *Managing for Results: The Statutory Framework for Performance-Based Management and Accountability*, GAO/GGD/AIMD-98-52 (Washington, D.C.: Jan. 28, 1998).

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violations. The last measure would help determine whether the agency's disgorgement orders were having a deterrent effect.

During this review, we found that SEC had developed a performance measure for timeliness and included it in the agency's 2004 annual performance plan but had not collected data on this measure or reported on its results. The agency's timeliness measure, according to SEC's 2004 Performance Plan, is the "number and percent of defendants/respondents subject to delinquent disgorgement orders during the fiscal year for which the Enforcement staff did not formulate a judgment recovery plan within 60 days after the debt became delinquent." This measure could potentially be useful in tracking staff efforts to recover delinquent debt and comply with SEC's recently established collection guidelines. However, in its 2004–2009 Strategic Plan and 2004 Performance and Accountability Report, SEC continued to use only the collection rate as its sole measure of collection performance. SEC staff acknowledged—and we have previously noted—that using only the collection rate had inherent limitations but added that the agency continued to use it because Congress and other agencies had come to expect that SEC would report the measure. While reporting the collection rate may serve other goals, it is not a meaningful performance measure and, as a result, SEC cannot fully determine the effectiveness of its collection program.

During this review, we calculated SEC's collection rate for all cases (open and closed), as well as a separate rate for closed cases only.<sup>25</sup> As shown in table 3, SEC's penalty collection rate for closed cases between September 2002 and December 2004 ranged from 72 percent to 100 percent and for all cases from 34 percent to 86 percent.

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<sup>25</sup>For our calculations, we defined open cases as "cases with a final judgment order that remained open while collection efforts continued" and closed cases as "cases with a final judgment order for which all collection actions were completed."

**Table 3: SEC's Collection Rates for CMPs Levied on All Cases and Closed Cases Only, September 2002– December 2004**

Fiscal year	Total CMPs on all (open and closed) cases			Total penalties on closed cases only		
	Amount levied	Amount collected	Percentage collected	Amount levied	Amount collected	Percentage collected
2002 <sup>a</sup>	\$3,770,872	\$1,277,004	34%	\$319,986	\$244,986	77%
2003	1,030,602,290	726,830,024	71	360,000	260,000	72
2004	1,206,475,410	1,041,613,639	86	1,190,000	1,190,000	100
<b>Total</b>	<b>\$2,240,848,572</b>	<b>\$1,769,720,667</b>	<b>79%</b>	<b>\$1,869,986</b>	<b>\$1,694,986</b>	<b>91%</b>

Source: GAO analysis of unaudited SEC data.

<sup>a</sup>Amounts included for 2002 are for September only. Amounts for the previous months in fiscal year 2002, totaling \$81.6 million, were reported in a prior report. SEC levied a total of \$85 million in 2002. The collected amounts include penalties that were due to SEC, courts, and court-appointed receivers.

While the percentage collected is a limited measure, as noted above, these rates represent a significant increase from the 40 percent collection rate for CMPs SEC averaged from January 1997 through August 2002. During 2003, SEC imposed about \$1 billion in penalties, up from about \$85 million in 2002. According to SEC staff, from September 2002 through August 2004, SEC brought enforcement actions against large, well-financed entities such as mutual funds and major corporations that had been accused of financial fraud. Because SEC collected most of the penalties imposed in these large cases, its collection rate was significantly higher than in previous years. SEC management told us that the agency's collection rate is heavily influenced by the nature of the entity that the agency sues and noted that, if SEC sued companies or issuers that were not well-financed, its collection rate would likely fall.

As shown in table 4, for disgorgement levied on closed cases between September 2002 and August 2004, SEC's collection rate ranged from 56 percent to 100 percent and from 13 percent to 34 percent for all cases during the same period.

**Table 4: SEC’s Collection Rate for Disgorgement Levied on All Cases and Closed Cases Only, September 2002–December 2004**

Fiscal year	Total disgorgement on all (open and closed) cases			Total disgorgement on closed cases only		
	Amount levied	Amount collected	Percentage collected	Amount levied	Amount collected	Percentage collected
2002 <sup>a</sup>	\$25,065,891	\$3,141,592	13%	\$514,617	\$288,700	56%
2003	1,028,469,833	249,750,377	24	28,919	28,919	100
2004	2,298,441,773	773,725,175	34	72,413	72,413	100
<b>Total</b>	<b>\$3,351,977,497</b>	<b>\$1,026,617,144</b>	<b>31%</b>	<b>\$615,949</b>	<b>\$390,032</b>	<b>63%</b>

Source: GAO analysis of unaudited SEC data.

<sup>a</sup>Amounts included for 2002 are from September only. Amounts for the previous months in fiscal year 2002 were reported in a prior report. The collected amounts include disgorgements that were due to SEC, courts, and court-appointed receivers.

These rates also represent a substantial increase over the collection rate of 14 percent for all cases involving a disgorgement order between 1995 and November 2001. We reported in 2002 that the collection rate for CMPs tends to be higher than the collection rate for disgorgement because SEC can take into account a violator’s ability to pay when imposing a penalty but cannot do so when imposing a disgorgement. We also reported that many violators ordered to pay a penalty are members of the securities industry and are motivated to pay their CMPs in order to maintain their reputation within the industry. However, we reported that many violators ordered to pay large disgorgement orders are either not members of the securities industry or have no desire to remain so. As we have discussed in previous reports, these factors make using the disgorgement collection rate as the sole performance measure problematic and highlight the need for SEC to continue its efforts to develop alternative performance measures for collection activities.

**SEC Is Working to Capture Data on Amounts Distributed and Receivers’ Fees**

In previous GAO reports, we determined that SEC did not have a centralized system for monitoring information on distribution amounts and receiver fees, making it difficult for the agency to assess the overall effectiveness of distribution efforts and ensure that harmed investors received the maximum amount of recovered funds. We recommended that SEC better manage disgorgement cases by tracking this information on both an aggregate and individual case basis. In the past, SEC stated that it did not believe that aggregating this data would help determine how well it was managing collection cases or that being able to assess the reasonableness of receiver fees would necessarily provide information on whether defrauded investors should have or could have received more

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funds. SEC had also identified a number of obstacles that hampered its ability to address our recommendation—for example, the CATS database, which was designed to track individual case information but not to aggregate it. Further, we were told that the agency lacked the information necessary to identify the amounts allocated to defrauded investors and receivers' fees, and SEC staff told us that they did not always know how much receivers were paid. As a result, the agency has had to rely on the courts to provide this information, but the courts have not consistently provided it.

During our work for this report, we learned that, despite its concerns about these obstacles, SEC had begun to make some progress in addressing this open recommendation. Specifically, SEC has updated CATS to identify distribution data and is in the process of drafting a standard form that will be used to request information from the courts on receivers' fees. If the courts respond to SEC's requests for this information, the agency should be better able to assess how well overall distribution efforts are working and whether harmed investors are being reimbursed the maximum amounts possible for actions taken against them by securities law violators.

### Uneven Supervision Reduces Assurance That Staff Are Following Collection Guidelines

In our 2002 study, we found that SEC's collection program lacked clear policies and procedures specifying the actions that staff should take to pursue collections. We commented that the lack of such guidance affected both staff and management, since staff were not held accountable to any clear standards and management could not determine whether staff took all collection actions promptly, or ensure that opportunities to maximize collection were not missed. We recommended that SEC develop and implement collection guidelines and develop controls to ensure that staff follow them. Consistent with the first part of this recommendation, SEC has developed and implemented collection guidelines that specify the various collection actions staff can take, explain when such activities should be considered, and stipulate how frequently they should be performed. SEC has also hired additional resources to perform specific tasks outlined in its collection guidelines. However, uneven supervision has reduced the assurance that staff are following these guidelines.

According to SEC management, the primary control in place to ensure that staff followed these guidelines is a periodic review, conducted by the lead collection attorney, of the 12 individual collection databases that collection

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staff use to track delinquent cases.<sup>26</sup> However, this periodic review may not be timely or effective since it could result in noncompliance with the guidelines or errors being undetected for an unspecified amount of time. Further, we found that some of the individuals involved in the collection process in some of SEC's regional offices—specifically monitors and case management specialists—have supervisors who are not directly involved and may lack detailed knowledge of the collection guidelines.<sup>27</sup> In addition, the level of supervision varies by location. For example, one of the regional case management specialists told us that an associate regional director oversees her work by reviewing a weekly CATS report that she generates. At another location, a case management specialist also told us that an assistant district administrator supervises her but does not formally monitor her work.

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### **Additional Concerns Could Impede SEC's Progress in Realizing the Benefits of Improved Collection Efforts**

We identified three additional new areas of concern that could impede SEC's progress in realizing the benefits of improved collection efforts. Specifically, we found that SEC lacks (1) a formal mechanism to monitor the effectiveness of the collection staff, (2) appropriate guidance and training for some collection staff, and (3) effective communication and coordination between two key units responsible for tracking collection activity. First, SEC does not have a formal mechanism to assess whether the increased collection resources are being used effectively. SEC management believes that the new collection resources have increased overall collection efforts and allowed enforcement attorneys to devote more time to investigating potential violations by reassigning some collection-related administrative duties. However, without a formal process for determining the effectiveness of the increased resources, SEC cannot validate these benefits. SEC management explained that they have focused their attention on making changes to the collection process in preparation for the first external financial audit and thus have not yet been able to focus on assessing the effectiveness of the collection staff's activities. As SEC's collection process stabilizes, a formal approach to gathering and analyzing input from Enforcement staff attorneys that have interacted with collection

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<sup>26</sup>As mentioned earlier, collection staff in SEC's headquarters, district, and regional offices are using ad hoc collection databases that are separate from CATS, in order to track the status of delinquent cases.

<sup>27</sup>The collection paralegals in headquarters are supervised by the lead attorney in the collection unit, who has detailed knowledge of the guidelines and ensure that they are followed.

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staff would help determine whether the new staff positions were being used effectively and whether any improvements could be made.

Second, our interviews with some of the case management specialists and collection monitors disclosed that some of the staff felt that they had not received sufficient guidance or training on new protocols for the collection procedures. SEC management told us that the agency had periodically added new protocols to the established procedures for tracking penalty and disgorgement data to help the agency prepare for its first external financial audit. In particular, SEC staff said that they had revised some internal controls and policies and procedures related to data entry and added additional data entry screens to CATS. Although new protocols addressing these changes have been communicated to the collection staff through various methods such as e-mails, monthly meetings, and monthly notifications, some of the collection staff identified the need for additional guidance. Moreover, some of them said that they would like to receive training on issues addressed in policy updates, as well as receive more formal training in how to interpret legal documentation such as judgments and how to work with FMS on collection issues. SEC management said that the agency has planned a workshop for the staff in late 2005 to provide information on these and related issues and anticipates that it will help meet some of the needs that staff have identified. Such attention should help the collection staff perform their duties more effectively.

Third, since August 2004, Enforcement and the Office of Financial Management (OFM) staff have shared responsibility for tracking and maintaining penalty and disgorgement data in CATS, but the units lack formal procedures to ensure that their staffs communicate and coordinate activities. To prepare for the external financial statement audit, SEC transferred responsibility for entering financial data in CATS from Enforcement to OFM, since penalty and disgorgement activity are recorded in SEC's financial statements. Under the terms of the transfer, Enforcement would still enter most of the case-related data into CATS, such as the names of defendants and dates of judgments and orders, and OFM would enter data on the amounts of money ordered, collected, and distributed. However, this division of responsibilities has not always been effective. For instance, Enforcement staff need timely and complete information on amounts that have been collected in order to take appropriate collection actions, but communication with OFM staff is not always consistent and timely, making coordination difficult. As an example, when OFM staff enter financial data into CATS, they do not always notify Enforcement, so that Enforcement staff must periodically check CATS to find out whether

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money has been collected and, in some instances, must contact OFM to determine the status of a case. Further, OFM is not always timely in entering data, resulting in delays that could hinder Enforcement staff's collection efforts.

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## SEC Emphasizes Its Commitment to Implementing the Fair Fund Provision but Has Been Slow in Distributing Funds and Assessing Results

SEC demonstrated its commitment to effectively implementing the Fair Fund provision of SOX by taking several steps. First, agency management has issued clear guidance to staff on how to generate Fair Fund monies from penalized offenders. As of April 2005, SEC has designated almost \$4.8 billion to be returned to harmed investors although, as of the date of this report, very little of it had been distributed, primarily because of time consuming tasks that have to be completed before distribution can take place. Second, we found that SEC staff had begun to collect and aggregate Fair Fund data to help in assessing the agency's performance in distributing funds to harmed investors. Finally, SEC has begun to address reporting requirements in its efforts to collect funds for distribution and in the methods it is using to maximize investor recovery.

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## SEC Has Issued Guidance on Implementing the Fair Fund Provision

According to SEC staff, the agency is committed to using the Fair Fund provision, which allows money from CMPs to be added to disgorgement amounts, to help defrauded investors obtain more of the funds owed to them. SEC has issued guidance to its staff on interpreting and applying the provision—for example, explaining that ordering a disgorgement for as little as \$1 can qualify a case as a Fair Fund case and make CMPs eligible for distribution. Among other cases, SEC applied this method in *SEC v. Lucent Technologies*, in which the company agreed to pay a settlement of \$25 million in CMPs and \$1 in disgorgement.<sup>28</sup> In this particular case, SEC charged the company and 10 individuals with fraudulently and improperly recognizing approximately \$1.148 billion of revenue and \$470 million in pretax income during fiscal year 2000—a violation of generally accepted accounting principles (GAAP).

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<sup>28</sup>*Securities and Exchange Commission v. Lucent Technologies, Inc., et al.*, No. 04-CV-2315 (May 17, 2004). One of the other defendants also agreed to pay disgorgement of \$109,505, representing profits gained as a result of the illegal conduct alleged in the complaint. SEC stated that it expected the penalties and disgorgement received from the four defendants of the settlement agreement to be distributed pursuant to the Fair Fund provision. *See* SEC Litigation Release No. 18715 (May 17, 2004).

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The guidance also highlights several other important aspects of the Fair Fund provision. It discusses the legal and practical aspects of seeking disgorgement, including estimating the amount the defendant obtained illegally.<sup>29</sup> It also instructs staff to include language preserving SEC's ability to establish a Fair Fund at a later date in cases that are settled early before it has been decided whether the Fair Fund provision will be invoked. Finally, SEC requires that language be added to judgments in all Fair Fund cases prohibiting violators from using amounts collected under a judgment to offset potential later judgments levied in third-party lawsuits. Because allowing such offsets could reduce the amount of money investors received in these lawsuits, the SEC language also stipulates that even if a court allows offset language in later judgments, the violator is obligated to pay the difference. This language is intended to aid attorneys in fairly and fully applying the Fair Fund provision and to help ensure that violators do not sidestep the intent of the Fair Fund provision.

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### SEC Has Successfully Used Fair Funds, but Distribution Has Been Slow

According to agency documents, SEC staff have successfully applied the Fair Fund provision in at least 75 cases since 2002 and, as a result of these efforts, more than \$4.8 billion in disgorgement and CMPs were designated for return to harmed investors as of April 2005. At the time of our review, although SEC has collected money for 73 of the 75 cases they identified, approximately \$60 million from only three cases have been distributed to harmed investors, and funds totaling about \$25 million from only one other case were being readied for distribution.

SEC's rules regarding Fair Funds and disgorgement funds states that "unless ordered otherwise, the Division of Enforcement shall submit a proposed plan no later than 60 days after the respondent has turned over the disgorgement..."<sup>30</sup> However, SEC staff observed that appointing a receiver to establish a plan for distributing funds can sometimes be a lengthy process that can be further complicated by factors beyond the agency's control. For example, in one case, an analysis of an extensive trading history had to be conducted, in order to determine issues such as the extent to which funds were diluted and the shareholders were harmed, and to determine how to deal with tax considerations for the distribution

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<sup>29</sup>SEC has the burden of showing that the amount that is sought in a disgorgement is a reasonable approximation of profits causally connected to the violation.

<sup>30</sup>17 C.F.R. § 201.1101.

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recipients. In another instance, a company agreed to pay \$80 million in disgorgement, CMPs, and interest, but a pending criminal indictment prevented SEC from distributing any funds until the criminal case is resolved. SEC acknowledged that the agency has an obligation to distribute funds to harmed investors in a timely manner and that SEC collection attorneys have begun to take on some of the tasks associated with distribution in an effort to expedite the distribution process. The collection attorneys also told us that they are working to develop a more standardized process for distributing funds to help ensure that staff attorneys perform this function properly.

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### SEC Has Started to Collect and Aggregate Fair Fund Data

During this review, we found that SEC implemented the Fair Fund provision without having a method in place to systematically track the number and amount of monies ordered, collected, and distributed, in part because CATS was not initially designed to identify this information. To gather information on Fair Fund cases, SEC management has had to request that staff attorneys submit ad hoc summaries of these cases, but the lack of a standard reporting format means that the information may be inconsistent. SEC management also has used data from CATS, Treasury's Bureau of Public Debt database, and discussions with attorneys to compile information on Fair Fund cases, but this method also has limitations because it does not employ a reliable data entry process using source documents that account for all the cases. Without reliable, accessible data, SEC is limited in its ability to evaluate the overall effectiveness of its implementation of the Fair Fund provision.

During this review, we found that SEC had started to take steps to track data on Fair Fund cases by adding fields to CATS that allow case management specialists to enter appropriate data, including receivers' fees, amounts distributed for Fair Fund and disgorgement cases, and amounts returned to Treasury. In addition, SEC staff said that information on all Fair Fund cases created before these modifications would be retroactively entered into the system. According to SEC management, SEC plans to compile and aggregate Fair Fund data, such as the number of cases and the associated monetary amounts, in order to better assess the provision's impact.

We also learned that SEC was using the amounts designated for return to harmed investors as an indicator of the program's success. For example, when describing the Fair Fund program in SEC's 2006 budget request, issued in February 2005, the agency stated that over \$3.5 billion in

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disgorgement and CMPs had been designated for this purpose. However, these amounts alone may not be appropriate measures of the program's success since harmed investors do not necessarily receive all the money. A more comprehensive indicator could include the amount of CMPs ordered as a direct result of the Fair Fund provision, the actual amounts distributed, and the length of time required to distribute the funds. SEC management told us that the agency plans to add an indicator on Fair Fund distribution to its agencywide performance "dashboard" that tracks the amount of funds returned to harmed investors.<sup>31</sup> Such an indicator would be a useful output measure but would not provide complete feedback on the effectiveness with which SEC executed its responsibilities. Nevertheless, to calculate its planned measure, SEC would have to collect data on how much money was actually returned to investors once taxes, fees, and other administrative costs were subtracted from the total amount collected.

#### SEC Has Complied with Other Aspects of Section 308

As required by Section 308(c) of SOX, SEC issued a report in January 2003 detailing the agency's efforts in collecting funds to be returned to harmed investors and the methods used to maximize this recovery.<sup>32</sup> The approaches involved "real time" enforcement initiatives such as temporary restraining orders, asset freezes, and the appointment of receivers to maximize recovery. SEC's report also suggested some legislative changes that would assist the agency in maximizing recovery for defrauded investors, including the following three:

- technical amendment to the Fair Fund provision that would permit SEC to include CMPs in Fair Funds for distribution to harmed investors in cases that do not involve disgorgement;
- proposal that excludes securities cases from state law property exemptions, so that violators could not use these "homestead" exemptions to shield their assets from judgments and administrative orders; and

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<sup>31</sup>The purpose of SEC's "dashboards" initiative is to regularly track divisions' and offices' progress in achieving programmatic, operational, staffing, and budgetary objectives. These management reports form the basis for SEC management to gauge performance, exchange ideas on common problems, and adjust operations and resources as necessary.

<sup>32</sup>SEC's Report to Congress: *Report Pursuant to Section 308 (c) of the Sarbanes Oxley Act of 2002, January 2003.*

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- grant of express authority to SEC to contract with private collection agents.

These proposed changes, in addition to others pertaining to enhancing enforcement capabilities and assisting defrauded investors, were included in H.R. 2179, the Securities Fraud Deterrence and Investor Restitution Act of 2003, which was introduced in the 108<sup>th</sup> Congress. The bill was reported favorably to the full House by the House Financial Services Committee, but no vote took place.<sup>33</sup>

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## CFTC Has Added Controls to Fingerprinting Procedures and Begun Making Timely Referrals to FMS

In our 2001 report, we recommended that CFTC take steps to ensure that delinquent CMPs were promptly referred to FMS. In our 2003 report, we also recommended that CFTC work with SEC and the SROs to address weaknesses in fingerprinting procedures to ensure that only appropriate persons are admitted to the futures industry. As part of this review, we found that CFTC fully addressed these remaining open recommendations. We also updated our calculation of CFTC's collection rates since our 2003 report (see appendix II).

In 2001, we recommended that CFTC implement its Office of Inspector General's (OIG) recommendation to create formal procedures to ensure that delinquent CMPs were sent to FMS within the required time frames. In an April 2001 report, CFTC's OIG found that CFTC staff were not referring the delinquent debts to FMS in a timely manner, potentially limiting FMS's ability to collect the monies owed. In 2004, CFTC's OIG followed up on this issue and determined that for the period from 2001 through 2004, CFTC had consistently complied with DCIA by referring delinquent debt to FMS within the allowable 180 days for collection services. CFTC's OIG reviewed 21 uncollected penalty cases out of a universe of 187 CMPs that were eligible for referral between October 1, 2001, and August 31, 2004. Of the 21 cases, 8 were excluded from referral to FMS because they were either referred to the Department of Justice for further review or were in litigation. CFTC's OIG found that of the remaining 13 cases, CFTC had sent

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<sup>33</sup>However, in regards to state law property exemptions, Section 322 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23, 96-97 (April 20, 2005), imposes a limitation on the value of exempt property that can be claimed by Chapter 11 debtors pursuant to state law, if the debtor owes a debt arising under a violation of federal securities laws. Section 322 will become effective in October 2005, but applies to Chapter 11 filings made on or after the date of enactment of the act.

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12 to FMS within the required time frame. One case was not received by FMS due to an undetected facsimile transmission error. CFTC officials have stated that their Enforcement division has changed the way it transmits information when referring cases and now uses certified mail, which provides a receipt to confirm that the information has been delivered.

During our 2003 study, we found that CFTC's statute, like SEC's, did not mandate that SROs such as NFA require member firms to ensure the validity of fingerprints submitted to the FBI by applicants of the futures industry. In response to our recommendation that CFTC address this weakness, CFTC, like SEC, worked with futures and securities regulators to prepare recommended guidance for best practices for fingerprinting procedures. According to CFTC officials, the agency agrees with the other task force members that issuing "best practices" guidance to the futures and securities industries could help prevent applicants from using someone else's fingerprints as their own. CFTC officials said that NFA made some adjustments to the fingerprinting guidelines developed by the task force to tailor them to the futures industry and that the updated guidance was made available to NFA members on July 29, 2005.

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## Conclusions

Over the past 2 years, SEC has undertaken a number of initiatives to enhance its ability to collect and track CMPs and disgorgement data and, to a lesser extent, monitor program effectiveness. SEC's initiatives represent a significant investment by the agency to improve its program. However, our recent audit of SEC's 2004 financial statement and this follow-up review showed that SEC needs to continue improving various aspects of its collection program. In response to our financial audit report, SEC has planned a number of corrective actions to address the identified control weaknesses related to the recording and reporting of penalty and disgorgement transactions. While SEC continues to address these internal control issues, it could also take steps to further maximize the effectiveness of its additional collection resources and strengthen the management of its collection program. Overall, SEC staff lacks some of the tools and support it needs to conduct collection and track collection data. In particular, the inadequacies that exist within the CATS database, uneven supervision of collection staff, and weak coordination between the two units responsible for tracking collection data collectively reduce the efficiency with which SEC staff carry out their responsibilities.

Just as important, SEC management also does not have the appropriate tools to evaluate the effectiveness of the agency's collection activities.

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Since expanding its collection staff, SEC has not formally assessed how additional resources have assisted in the collection process and alleviated staff attorneys' responsibilities. Without a formal approach, SEC is not able to determine whether its resources are being optimally utilized. SEC also still does not have meaningful performance measures to assess the effectiveness of the agency's collection activities, inhibiting management's ability to identify and make adjustments as needed. Finally, SEC management has started to collect data to centrally monitor distribution activities to assess how well it is returning disgorgement funds to harmed investors, but these actions have not yet been completed.

The Fair Fund provision has allowed for the potential for greater return of monies to harmed investors from securities laws violators. SEC has demonstrated its commitment in using this provision, and its implementation efforts are noteworthy. Nevertheless, to date, the majority of the monies collected under the provision have not been distributed to harmed investors. We recognize that, as with other distribution funds, the complexity and circumstances of a case could contribute to the lapse in time between the collection of the monies and subsequent distribution. However, because of SEC's traditional focus on deterring fraud and the relatively few distributions that have taken place, we are concerned that SEC may not be able to ensure the timely distribution of the growing sum of money that has been collected as a result of the establishment of Fair Funds. At a minimum, SEC should have reliable and meaningful data available to monitor the timely and complete distribution of Fair Fund monies.

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## Recommendations for Executive Action

SEC has taken actions to strengthen its data tracking and management practices for its penalty and disgorgement collection program. However, the agency could take additional steps to ensure that collection staff members have the necessary tools and support to carry out their responsibilities efficiently and are being used effectively. Therefore, we recommend that the Chairman, SEC, take the following three actions:

- Develop a method to ensure that case management specialists and collection monitors in Enforcement receive consistent supervision and the necessary monitoring and guidance to carry out their duties and that SEC management can ensure that staff are following the collection guidelines.

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- Establish procedures for staff in the OFM to notify Enforcement staff on a timely basis about data entered into CATS.
  - Determine the effectiveness of new case management specialists, collection monitors, and collection attorneys by using formal approaches such as periodically surveying staff attorneys that interact with collection staff to evaluate the assistance the staff provides.

In addition, we recommend that the Chairman, SEC, take the following three actions, including two that we have previously recommended, to continue to ensure that the collection program meets its goal of effectively deterring securities law violations and returning funds to harmed investors:

- Continue to identify and establish appropriate performance measures to gauge the effectiveness of collection activities and begin collecting and tracking data to implement the timeliness measure presented in SEC's 2004 annual performance plan, if SEC still considers that measure appropriate.
- Ensure that management determines, on an aggregate basis, (1) the amount of disgorgement distributed each year to harmed investors, (2) the amount of CMPs sent to Treasury, and (3) the amount of receivers' fees and other specialists' fees and that the agency uses this information to more objectively monitor the distribution of monies to harmed investors.
- Ensure that management establishes a procedure for consistently collecting and aggregating its Fair Funds data to assist in the monitoring and managing of the distribution of monies to harmed investors and establishes measures to evaluate the timeliness and completeness of distribution efforts.

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## Agency Comments and Our Evaluation

We requested comments on a draft of this report from SEC and CFTC. Both agencies provided technical comments, which we have incorporated into the final report, as appropriate. SEC also provided written comments that are reprinted in appendix III. In its comments, SEC acknowledged that the Division of Enforcement's efforts in data tracking and management practices are still in their early stages, but said that the agency is working diligently to strengthen its collection program. SEC also expressed agreement with our findings and all six of our recommendations and said that it is working to implement each of the recommendations.

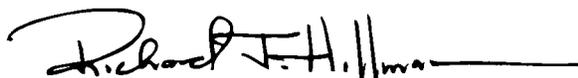
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Specifically, SEC is in the process of (1) developing reports and training programs that will allow for consistent monitoring of the collection program nationwide, (2) developing a system by which OFM can notify Enforcement about data entered into SEC's case tracking system, (3) determining the effectiveness of new collection processes and staff, (4) revising current performance measures to more effectively determine program performance, (5) collecting information on the amount of penalties and disgorgement distributed to investors and paid to receivers, and (6) developing systems to collect data on Fair Fund cases.

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As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time we will provide copies of this report to the Chairmen and Ranking Minority Members of the Senate Committee on Banking, Housing, and Urban Affairs and its Subcommittee on Securities and Investment; the Chairmen, House Committee on Financial Services and its Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises; and other interested congressional committees. We will also send copies to the Chairman of SEC, the Chairman of CFTC, and other interested parties. We also will make copies available to others upon request. In addition, the report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact me at (202) 512-8678 or [hillmanr@gao.gov](mailto:hillmanr@gao.gov). Contact points for our Office of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix IV.



Richard J. Hillman  
Managing Director, Financial Markets  
and Community Investment

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# Objectives, Scope, and Methodology

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To discuss the Securities and Exchange Commission's (SEC) progress in addressing recommendations made in our 2002 and 2003 reports that were aimed at improving the agency's tracking of data on civil monetary penalties (CMP) and disgorgement, we interviewed staff in SEC's Division of Enforcement (Enforcement), Office of Financial Management (OFM), and Office of Information Technology (OIT) to obtain information on efforts they have made to implement the recommendations.<sup>1</sup> To gain further information on SEC's activities in upgrading its tracking system, we reviewed relevant documents, such as an internal Case Activity Tracking System (CATS) data entry guide (with associated procedures), sample data entry forms completed by Enforcement attorneys, a draft systems definition document for an upgraded case tracking system prepared by an SEC-hired contractor, an assessment of the accuracy and completeness of CATS data conducted by SEC's Office of Inspector General, and GAO's audit of SEC's financial statements for fiscal year 2004.<sup>2</sup> To assess the reliability of penalty and disgorgement data that SEC provided for the calculation of its collection rate, we interviewed staff in Enforcement and OFM about the new policies and procedures for entering data into CATS. We selected a random sample of 45 cases tracked in CATS to test the improved procedures by (1) reviewing case files for valid supporting source documents maintained by Enforcement staff, including final judgments, administrative orders, and court dockets, and (2) verifying data accuracy for penalty and disgorgement amounts ordered by comparing data recorded in source documents with data entered in CATS as of March 2005. We concluded that for purposes of this report, the data provided by SEC were sufficiently reliable.

To assess the steps SEC has taken to address our earlier recommendations on its management of the collection program and related issues, we conducted relevant testing of procedures, including those related to referrals and approvals of compromise offers, interviewed staff from SEC and other agencies involved in SEC's collection activities, and reviewed pertinent documents.<sup>3</sup> Specifically, to evaluate the effectiveness of SEC's procedures for referring delinquent cases to the Department of the Treasury's (Treasury) Financial Management Service (FMS) both before

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<sup>1</sup>[GAO-03-795](#) and [GAO-02-771](#).

<sup>2</sup>Securities and Exchange Commission, *Office of the Inspector General: CATS 2000 Data*, Audit No. 331 (Washington, D.C.: Jan. 30, 2002) and [GAO-05-244](#).

<sup>3</sup>[GAO-03-795](#), [GAO-02-771](#), and [GAO-01-900](#).

and after the collection guidelines were established, we interviewed SEC staff to discuss the activities they took recently to refer delinquent cases to FMS.<sup>4</sup> Using our sample of 45 cases, we identified those that met the criteria for referral and used FMS's records to verify that the cases had been referred and determine how quickly SEC submitted the referrals. Next, to assess SEC's efforts to address our 2003 recommendation that the agency work with the securities and futures self-regulatory organizations (SRO) to address weaknesses in controls over fingerprinting procedures, we interviewed SEC staff to discuss actions taken since we made our recommendation and the status of the fingerprinting guidelines. We also obtained a draft copy of the guidelines and reviewed the additional controls that had been proposed to prevent inappropriate persons from being admitted to the securities industry.

To assess SEC's progress in tracking SROs' disciplinary actions and in implementing a new database to track them—a recommendation from our 2003 report—we reviewed the results of the analyses that SEC's Office of Compliance Inspections and Examinations (OCIE) conducted of these actions, as of May 2005, and an internal planning document that OIT had prepared. We also interviewed OCIE and OIT staff about the efforts each office had made to address the recommendation. Further, to address a recommendation related to approval of compromise offers from FMS, we assessed SEC's efforts to improve its timeliness by obtaining and analyzing data from SEC and FMS on all of the 12 compromise offers presented by FMS between July 15, 2003, and January 6, 2005, to determine whether SEC had met its internal time frame. We also interviewed SEC and FMS staff to discuss the effectiveness of SEC's policies and procedures and to obtain information on SEC's efforts to work with FMS to ensure the timely approval of offers.

In addition, to determine whether SEC had implemented our 2002 recommendation that it complete an evaluation of options for addressing its competing priorities and increasing workload by assessing the feasibility of contracting out certain collection functions or increasing staff devoted to collections, we reviewed SEC's study pursuant to a mandate in Sarbanes-Oxley Act of 2002 (SOX) to obtain the results of the feasibility

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<sup>4</sup>We included both pre- and post-collection guideline cases for penalties and disgorgement, because the collection guidelines apply equally to both.

assessment.<sup>5</sup> We also reviewed and followed up on the status of the Securities Fraud Deterrence and Investor Restitution Act, introduced in the 108<sup>th</sup> Congress, which included a number of legislative proposals that SEC had recommended in its study, such as contracting with private collection agencies to collect delinquent debt owed to the agency.<sup>6</sup> Further, we interviewed SEC staff to discuss recent measures taken by the agency to increase its collection staff. Moreover, to determine if SEC had established alternative measures to its collection rates, as recommended in our 2002 report, we reviewed the agency's 2004-2009 Strategic Plan, 2004 Performance Plan, and 2004 Performance and Accountability Report for collection indicators and interviewed staff in Enforcement to obtain their views on using alternative measures. In addition, to determine whether SEC had promptly implemented its collection guidelines and taken action to ensure that staff followed them, we reviewed the collection guidelines and job descriptions for case management specialists. We conducted structured interviews with nine collection staff members, including two attorneys, one regional collection monitor, one paralegal, and five case management specialists, three of whom also perform collection monitors' duties, to discuss their duties in relations to the collection guidelines and their views on the level of training they have received. SEC management selected these individuals based on our criteria that we speak with one-third of the new collection staff. These staff members worked in headquarters and regional offices in Atlanta, Boston, Denver, and Miami. Finally, we reviewed collection checklists and screen printouts from the databases used by collection staff and interviewed SEC officials who manage the collection program and staff to discuss their role in SEC's case tracking and collection process.

To evaluate SEC's implementation of the Fair Fund provision, we reviewed Section 308 (a-c) of the act and performed a legislative search and legal analyses. To determine how and when SEC applies the provision, we reviewed information from SEC's Web site, the agency's CATS database, a sample of distribution plans and rulings on cases to which the Fair Fund provision had been attached, and SEC's Rules on Fair Fund and Disgorgement Plans and interviewed relevant SEC staff. Further, to determine the number of cases and the amount of CMPs and disgorgement

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<sup>5</sup>The feasibility assessment was part of a study done in response to SOX, SEC: *Report Pursuant to Section 308(c) of the Sarbanes Oxley Act of 2002* (Washington, D.C.: January 2002).

<sup>6</sup>H.R. 2179.

ordered and collected since the SOX was implemented in 2002, we reviewed two internal documents that summarized Fair Fund cases and amounts dated June 30, 2004, and April 22, 2005, and interviewed SEC staff on their use of the data. In addition, to gain a better understanding of the distribution process, we interviewed SEC staff on the data and controls they used to ensure that appropriate amounts were being returned to harmed investors. Moreover, Section 308(c) of SOX required that SEC report on (1) enforcement actions that SEC took to obtain CMPs or disgorgement for the 5-year period prior to the act's implementation and (2) methods SEC used to ensure that injured investors were being fairly compensated. SEC issued this report in January 2003, and we reviewed it to determine if SEC had met the legislation's requirement. We also performed a legal analysis to assess whether receiving Fair Funds affected a harmed investor's ability to sue a violator through private litigation.

To describe the actions CFTC has taken to address previous recommendations, we interviewed relevant CFTC staff, reviewed collection documents they provided and relied on CFTC's Office of Inspector General's (OIG) work. Specifically, to determine whether CFTC had complied with the Debt Collection Improvement Act of 1996 by referring delinquent debt to FMS, we relied primarily on CFTC OIG's findings associated with this recommendation. In particular, we reviewed the OIG's 2004 and 2001 audit reports and supporting work papers for our assessment of the timeliness of referrals. We also reviewed CFTC's documents describing its collection workflow and processes and interviewed CFTC's OIG staff and CFTC staff to discuss CFTC's procedures on referring debt to FMS. Furthermore, to assess the actions CFTC has taken to address our recommendation on strengthening fingerprinting controls, we conducted our work on CFTC and SEC simultaneously. We obtained a copy of the draft for the new fingerprinting guidelines and reviewed them for additional controls to preclude inappropriate individuals from being admitted to the futures industry.

Finally, to calculate SEC's collection rates for CMPs and disgorgement and CFTC's collection rates for CMPs and restitution, we requested data from each agency on the amount of these sanctions ordered from September 2002 through August 2004 and collected through December 2004. We chose September 2002 as the beginning of our time period in order to pick up where our 2003 report ended. As with our 2003 report, we limited our review to CMPs, disgorgement, and restitution ordered through August 2004 to allow SEC and CFTC through December 2004 (4 months) to attempt collections. Also consistent with our 2003 report, we calculated SEC's and

CFTC's collection rates for all cases (open and closed cases) and closed cases only.<sup>7</sup> For purposes of our calculation, we defined open cases as "cases with a final judgment order that remained open while collection efforts continued" and closed cases as "cases with a final judgment order for which collection actions were completed." We relied on SEC and CFTC to categorize cases as being open or closed, consistent with the above definition. We did not independently verify either SEC or CFTC's classification of a case as being open or closed. For data provided by both agencies, we performed basic tests of the data's integrity, such as checks for missing records and obvious errors. We concluded that the data provided by SEC and CFTC, for purposes of this report, were sufficiently reliable.

We conducted our work from August 2004 to August 2005 in Washington, D.C., in accordance with generally accepted government auditing standards.

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<sup>7</sup>In our 2003 report, we also calculated the penalty collection rate for nine self-regulatory organizations, in addition to SEC and CFTC.

# CFTC's Penalty and Restitution Collection Rates

We calculated the Commodity Futures Trading Commission's (CFTC) civil monetary penalties (CMP) and restitution collection rates to provide updated information on CFTC's activities through December 2004. As in our 2003 report, we calculated CFTC's collection rate for all cases (open and closed) and closed cases only.<sup>1</sup> As shown in table 5, from September 2002 through December 2004, CFTC's CMPs collection rate for all cases ranged from 38 percent to 100 percent and for closed cases only from 98 percent to 100 percent.

**Table 5: CFTC's Collection Rates for CMPs Levied on All Cases and on Closed Cases Only, September 2002–December 2004**

Fiscal year	Total CMPs on all (open and closed) cases			Total CMPs on closed cases only		
	Amount levied	Amount collected	Percentage collected	Amount levied	Amount collected	Percentage collected
2002 <sup>a</sup>	\$225,000	\$225,000	100%	\$225,000	\$225,000	100%
2003	137,313,266	87,410,107	64	78,697,174	77,307,229	98
2004	320,889,522	121,899,500	38	121,889,500	121,769,500	99.9
<b>Total</b>	<b>\$458,427,788</b>	<b>\$209,534,607</b>	<b>46%</b>	<b>\$200,811,674</b>	<b>\$199,301,729</b>	<b>99%</b>

Source: GAO analysis of CFTC's data.

<sup>a</sup>Amounts included for 2002 are from September only. Amounts for the previous months in fiscal year 2002 were reported in a prior report. According to data CFTC provided, during 2003 there were 12 cases totaling \$5,557,680 that were neither open nor closed but were on appeal for which CFTC collected \$0. Similarly, during 2004, there were two cases totaling \$626,000 that were neither open nor closed but were on appeal for which CFTC collected \$0.

Like the Securities and Exchange Commission (SEC), CFTC also imposed significantly larger amounts of CMPs from September 2002 through December 2004 compared with previous years. For example, during 2003 CFTC imposed about \$137 million in CMPs, up from \$15.6 million in 2002. According to CFTC officials, there were three reasons for the increase. First, in 2002, CFTC was reorganized to leverage the Enforcement's investigation and litigation resources. This reorganization allowed the division to file more cases and ultimately it entered into an increased number of judgments imposing a penalty. Second, by 2003, the Enforcement division was engaged in an industrywide investigation of the energy sector concerning attempted manipulation and false reporting conduct, and settlements in these cases resulted in the imposition of

<sup>1</sup>For purposes of our calculations, we defined open cases as "cases with a final judgment order that remained open while collection efforts continued" and closed cases as "cases with a final judgment order for which all collection actions were completed."

**Appendix II**  
**CFTC's Penalty and Restitution Collection**  
**Rates**

approximately \$250 million in CMPs. Third, following reauthorization in 2001, CFTC's jurisdiction over investigations of foreign exchange fraud was clarified; since that time, CFTC has begun to file more actions in this area. In one case, according to CFTC officials, a court entered separate judgments against the named defendants, imposing approximately \$75 million in CMPs.

However, unlike SEC's collection activity, CFTC's collection rate for CMPs did not significantly increase over previous years. For example, from September 2002 through December 2004 CFTC's CMPs collection rate for all cases was 46 percent. From January 1997 through August 2002, the agency's collection rate was 45 percent.

As shown in table 6, CFTC's collection rate for restitution ranged from 4 percent to 8 percent for all cases and was 100 percent for closed cases only.

**Table 6: CFTC's Collection Rate for Restitution Levied on All Cases and on Closed Cases Only, September 2002–December 2004**

Fiscal year	Total restitution on all (open and closed) cases			Total restitution on closed cases only		
	Amount levied	Amount collected	Percentage collected	Amount levied	Amount collected	Percentage collected
2002 <sup>a</sup>	0	0	0	0	0	0
2003	\$77,133,613	\$6,461,706	8%	\$83,260	\$83,260	100%
2004	102,169,341	3,772,249	4	0	0	0
<b>Total</b>	<b>\$179,302,954</b>	<b>\$10,233,955</b>	<b>6%</b>	<b>\$83,260</b>	<b>\$83,260</b>	<b>100%</b>

Source: GAO analysis of CFTC's data.

Note: According to data CFTC provided, during 2003, one case totaling \$219,250 was on appeal and, therefore, CFTC has not yet collected anything. Similarly, during 2004, one case totaling \$276,557 was on appeal and so far has netted CFTC nothing. CFTC did not collect any restitution for closed cases during 2004.

<sup>a</sup>Amounts included for 2002 are for September only. Amounts for the previous months in fiscal year 2002 were reported in a prior report.

# Comments from the Securities and Exchange Commission



UNITED STATES  
**SECURITIES AND EXCHANGE COMMISSION**  
100 F Street, N.E.  
Washington, D.C. 20549

**DIVISION OF  
ENFORCEMENT**

August 19, 2005

Mr. Richard J. Hillman  
Managing Director  
Financial Markets and Community Investment  
U.S. Government Accountability Office  
441 G Street, N.W.  
Washington, DC 20548

Re: SEC and CFTC Enforcement

Dear Mr. Hillman:

Thank you for the opportunity to review and comment on the draft report primarily concerning the Securities and Exchange Commission's ("Commission") collection efforts regarding penalties and disgorgement and implementation of the Sarbanes-Oxley Act's Fair Funds provision. The report discusses how the Commission's Division of Enforcement has complied with recommendations in prior reports and has taken positive steps in this regard. In addition, the report makes recommendations regarding how the Commission can most effectively continue to meet its goal of deterring securities law violations and returning funds to harmed investors.

I appreciate the collegiality your staff exhibited in preparing the report and in discussing its findings and recommendations with my staff. As the report points out, the Division of Enforcement's efforts in data tracking and management practices for penalties and disgorgement are still in their early stages, but we are working diligently to strengthen our program.

Furthermore, we agree with your findings and recommendations and are working to implement them. Our specific comments are as follows:

I. Supervision, Monitoring, and Guidance Related to Collections Guidelines and Duties

The draft report recommends that we develop methods to ensure that those doing collection work receive consistent supervision, monitoring, and guidance to carry out their duties and implement systems so that management can monitor compliance with the collections guidelines. We agree with this finding and recommendation and are developing reports that will allow us to monitor the collections program nationwide. These reports will permit management to exercise consistent supervision of the program and monitoring of compliance with the

Mr. Richard J. Hillman  
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guidelines. We also are preparing training programs for our staff to enhance guidance in this area.

II. OFM Notification to Enforcement

Your draft report recommends that the staff develop systems whereby OFM can notify Enforcement regarding data that OFM has entered into the system. We agree that enhanced communication with OFM staff can improve the efficiency of our case management and collections staffs. As the SEC develops the new system to replace the financial functionality of CATS, this need will be accommodated. Interim measures will be considered as well.

III. Determine Effectiveness of New Processes

Your draft report notes that we have recently implemented a number of new processes and hired new staff to fulfill these duties. You suggest that as the collection process stabilizes, we adopt a formal approach to gain input to determine the effectiveness of these processes and what improvements we can make. We agree that after the program stabilizes, we will determine how we can best evaluate the effectiveness of this program and where we need to make improvements.

IV. Performance Measures for Collections

The draft report recommends that we continue to identify, establish, and utilize performance measures to gauge the effectiveness of our collections activities. We agree and are working to revise our performance measures in this area so that we can most effectively determine our performance.

V. Aggregate Analysis of Distributions

You recommend that we aggregate the amount of money distributed to investors, penalties sent to Treasury, and fees paid receivers, and that we use this information to monitor distributions to investors. As we have discussed with you, we are working to collect information on the amount of money distributed to investors. We currently have aggregate numbers regarding the amount of disgorgement and penalties sent to Treasury. We are in the process of developing systems to track the fees paid to receivers. When we are able to start accumulating this information, we will analyze how it can best be utilized so we can most effectively distribute money to investors.

VI. Fair Funds Data Collection

The draft report recommends that we establish a procedure for collecting Fair Funds data to assist us in monitoring and managing money distributed to investors. We agree and are working diligently to develop these systems.

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**Appendix III**  
**Comments from the Securities and Exchange**  
**Commission**

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Mr. Richard J. Hillman  
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We appreciate the care that is evident in the draft report and its recommendations. If we can be of any further assistance, please contact me at (202) 551-4894 or Joan McKown at (202) 551-4933.

Yours truly,

*Linda Chatman Thomsen* /*nab*

Linda Chatman Thomsen  
Director

# GAO Contact and Staff Acknowledgments

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## GAO Contact

Richard J. Hillman (202) 512-8678

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## Staff Acknowledgments

In addition to the individual named above, Karen Tremba, Assistant Director, Emily Chalmers, Ronald Ito, Grant Mallie, Bettye Massenburg, Marc Molino, David Pittman, Carl Ramirez, Omyra Ramsingh, and Cheri Truett made key contributions to this report.

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