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GAO

Report to Congressional Requesters

July 2002

SEC ENFORCEMENT

More Actions Needed to Improve Oversight of Disgorgement Collections

GAO-02-771

Contents

Abbreviations

DPTS	Disgorgement Payment Tracking System
GPRA	Government Performance and Results Act of 1993, P.L. 103-62
SEC	Securities and Exchange Commission

GAO
Accountability * Integrity * Reliability

United States General Accounting Office
Washington, D.C. 20548

July 12, 2002

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

The Honorable John J. LaFalce
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

Every year some investors lose money to individuals and corporations that violate federal securities laws. Part of the mission of the Securities and Exchange Commission (SEC) is to deter such violations and, where possible, return lost funds to investors who have been harmed. One of SEC's primary tools for achieving these goals is the disgorgement order, which requires violators to give up money obtained through securities law violations. In order for disgorgement to succeed both as a deterrent and as a means of returning funds to harmed investors, SEC must have an effective disgorgement collection program.

Although the courts have ordered billions of dollars in disgorgement in the last decade, concerns exist about SEC's success in collecting these funds. We reported on SEC's disgorgement collection program in 1994 and made several recommendations designed, among other things, to help SEC better assess the effectiveness of its disgorgement collection efforts.[1] That report also included recommendations relating to SEC's oversight of the receivers appointed by courts to collect and distribute disgorged funds. A January 2001 press article reported that SEC's disgorgement collection rate had

[1]U.S. General Accounting Office, *Securities Enforcement: Improvements Needed in SEC Controls Over Disgorgement Cases*, GAO/GGD-94-188 (Washington, D.C.: Aug. 23, 1994).

declined significantly since our 1994 report, raising questions about the ongoing effectiveness of SEC's collection program.[2] Finally, a recent report by SEC's Inspector General[3] raised concerns about the process SEC uses to waive some or all of a disgorgement amount based on the violator's financial condition. At your request, this report focuses on SEC's current disgorgement collection efforts. Specifically, we (1) discuss the usefulness of the collection rate as a measure of the effectiveness of SEC's collection efforts, (2) assess SEC's program for collecting disgorgement, (3) evaluate the changes in SEC's process for recommending receivers and monitoring their activities, and (4) evaluate the improvements in SEC's process for recommending waivers of disgorgement amounts.

To determine the usefulness of the collection rate as a measure of SEC's collection efforts, we analyzed information in SEC's disgorgement database to calculate a single collection rate for 1995 to 2001[4] and individual rates from 1989 until 1999. As part of this, we also assessed the reliability of the database by comparing its data to that contained in a sample of case files from three SEC offices. These files included 35 civil disgorgement cases judgmentally selected for a range of characteristics, such as whether collections had been successful or whether receivers had been appointed, and the 10 largest disgorgement orders from 1995 through 2000, which represented a significant portion of the total disgorgement amount ordered during that period. We also spoke with officials from SEC, private collection agencies, and other federal agencies that conduct collection activities to learn how various factors can affect SEC's ability to collect disgorgement and the resulting collection rate. To assess SEC's disgorgement collection program, we reviewed SEC's strategic and annual plans to determine how these plans addressed disgorgement collections. To identify the actions that SEC staff had taken to collect and distribute disgorgement amounts, we reviewed the files from our judgmental sample of cases and spoke with the SEC staff familiar with these cases. To evaluate the changes in SEC's process for recommending receivers, we reviewed related policies and procedures and examined 10 recent receiver recommendations to verify compliance with these procedures. To review

[2]Kevin McCoy, "Conned Investors May Never See Refunds: SEC Collection Rate Falls Sharply Since 1994," *USA Today*, Jan. 9, 2001, final edition.

[3]Securities and Exchange Commission, *Office of the Inspector General: Disgorgements*, Audit No. 311 (Washington, D.C.: Jan. 11, 2001).

[4]Unless otherwise noted, years presented are fiscal years ending September 30.

SEC monitoring of receivers, we examined seven cases to determine what actions SEC staff took to oversee receiver activities and spoke with three receivers appointed to SEC disgorgement cases on the extent to which they interacted with SEC staff. To evaluate the improvements in the waiver recommendation process, we reviewed 10 cases with partial and full waivers for which final judgments had been ordered in fiscal year 2001. Because we judgmentally selected our case file sample, the results of our case file reviews may not be representative of all SEC disgorgement cases. Appendix I contains a full description of our scope and methodology.

Results in Brief

For several reasons, SEC's disgorgement collection rate is not adequate as a measure of the effectiveness of SEC's disgorgement program. First, while SEC data showed a collection rate of 14 percent for the $3.1 billion in disgorgement ordered in 1995–2001—compared with the 50 percent collection rate we reported in our 1994 report—we found that the rate varied widely from year to year and was heavily influenced by large individual disgorgement orders. Second, the data used to calculate the collection rate was not reliable because of weaknesses in the procedures for entering and updating information in SEC's disgorgement tracking database. These weaknesses resulted in inaccuracies in the amounts of disgorgement ordered, collected, and waived and, as a result, we could not determine SEC's actual disgorgement collection rate. Third, factors beyond SEC's control, including violators' inability to pay, reduce the likelihood that SEC will be able to collect the full amount of disgorgement ordered.

To deprive securities law violators of illegally obtained funds, SEC needs an effective collection program with clearly defined objectives and measurable goals, specific policies and procedures for its staff, and systems to allow management to monitor performance. However, SEC's strategic and annual performance plans do not address disgorgement collection or clarify its priority relative to other activities. SEC also has not developed performance measures and, therefore, lacks the information necessary to evaluate the program's effectiveness. Without such guidance and measures, competing priorities and increasing workloads could prevent SEC staff from pursuing collection activity to the degree desired by the agency. SEC is assessing some ways to address this issue, including contracting out some collection activities and dedicating more staff to collections, but does not have a time frame for completing or taking action on its assessment. Another weakness we identified was that SEC did not have in place specific policies and procedures that would provide staff with guidance on the type, timing, and frequency of collection actions they

should consider and help them understand what is expected of them. Near the end of our review, SEC officials provided us with draft collection guidelines that they plan to implement by the end of July 2002, but had not fully developed the means they would use to ensure the guidelines are followed. Without such guidance and controls, SEC management cannot ensure that sufficient and appropriate collection efforts are being made consistently across all cases. Finally, SEC management did not have reliable, accessible information it could use to ensure that collected funds are distributed promptly to investors.

SEC has improved its process for recommending receivers to work on disgorgement cases and has taken steps to monitor receivers' actions, but lacks a mechanism for tracking receiver fees. Court-appointed receivers perform a variety of tasks, such as gathering and liquidating a violator's assets and distributing the funds collected to harmed investors. In July 2001, SEC implemented revised guidelines for recommending receivers to the court. These guidelines are designed to ensure that the recommendations are made objectively and that the justification for each recommendation is documented. We reviewed a sample of recent receiver recommendations and found that, in general, the procedures were being followed. We also found that SEC staff were monitoring receivers' activities and gathering enough information to assess receivers' fee applications. However, SEC does not have a system for tracking individual case data on receivers' fees, as we recommended in our 1994 report. Some receiver's duties can be complex, and consequently their fees can sometimes exceed half the funds collected. Tracking this information could improve management's ability to identify cases in which receiver's fees are high. In turn, identifying these cases would make it easier to take prompt action to minimize costs, so that harmed investors receive as much money as possible.

In response to concerns noted in a recent internal report, SEC also has improved its waiver recommendation process for disgorgement orders. An audit completed in June 2000 by SEC's Inspector General found that SEC could improve its ability to provide reasonable assurance that the violators were unable to pay the entire disgorgement amount or that all assets had been identified. The Inspector General recommended that SEC improve its procedures for verifying violators' financial information. These improvements included using databases and analyzing insurance policies, tax returns, and passports to identify possible leads for detecting fraudulent information or hidden assets. In October 2000, SEC implemented new guidelines that incorporated the improvements

recommended by the Inspector General. We reviewed a sample of recent waiver recommendations and found that SEC staff were following the revised guidelines.

This report includes recommendations to the SEC Chairman to improve SEC's ability to ensure the effectiveness of its disgorgement collection program. These recommendations include (1) ensuring the reliability of disgorgement data, (2) delineating the objectives of the disgorgement program and including measures of its effectiveness in SEC's strategic and annual plans, (3) addressing the competing priorities within SEC's Division of Enforcement, (4) finalizing collection guidelines, and (5) monitoring the distribution of disgorgement. We received comments on a draft of this report from the director of SEC's Division of Enforcement. SEC agreed with most of the report's conclusions and recommendations and stated that the agency is already implementing some of the most important recommendations. SEC's comments are discussed in greater detail at the end of this letter, and its written comments are reprinted in appendix II.

Background

As the organization charged with responsibility for overseeing U.S. securities markets at the federal level, SEC's mission is to protect investors and ensure fair and orderly markets. Within SEC, the Division of Enforcement is responsible for investigating possible violations of the securities laws, litigating against violators in federal civil courts and administrative proceedings, and negotiating settlements. When an investigation reveals a possible violation, SEC can seek a range of sanctions and remedies, including disgorgement. When seeking disgorgement, SEC staff attempt to recover the amount of illegal profits or misappropriated funds as a way of ensuring that securities law violators do not profit from their illegal activities. When possible, SEC also attempts to return these funds to any investors harmed as a result of the violation. When it is not economically practical or efficient to locate and notify investors, the collected amounts are transferred into the general fund of the U.S. Treasury. Disgorgement sanctions are imposed against violators involved in activities such as insider trading, investment adviser fraud, market manipulation, and fraudulent financial reporting. Until 1990, SEC could obtain a disgorgement sanction only by obtaining a court order from a civil suit filed in federal district court. However, in 1990, Congress gave SEC the authority to impose disgorgement sanctions in its administrative proceedings through the Securities Enforcement Remedies and Penny Stock Reform Act of 1990. The majority of disgorgement orders result from suits filed in federal court.

The amount to be disgorged in civil and administrative proceedings is based on the amount of the illegal gain, but SEC has discretion to waive all or part of a disgorgement claim. Waivers are granted based on a violator's inability to pay and are typically granted in settled matters. If SEC believes that a violator is able to pay but refuses to make payments, it can take actions to compel the violator to pay, such as requesting that the court hold the violator in contempt for failure to pay. In addition, SEC may request that the court appoint a receiver, generally a private sector lawyer, to perform certain tasks, such as obtaining and managing a violator's assets and overseeing the distribution of funds to harmed investors. Receivers are paid out of the funds collected to pay the disgorgement order.[5] After SEC exhausts all practical collection actions, the agency is required to transfer its uncollected debt to the Treasury Department's Financial Management Service for final collection efforts.

As we have stated in two recent reports, SEC faces several challenges in fulfilling its mission.[6] U.S. securities markets have grown tremendously and become more complex and international, increasing the volume and complexity of SEC's workload. SEC's staff resources have not increased at a similar rate. For example, between 1991 and 2000, Division of Enforcement staff devoted to investigations increased 16 percent, from 414 to 482 staff years, while the number of cases opened increased 65 percent, from 338 to 558. In addition, the number of cases pending at the end of the year increased 77 percent, from 1,264 in 1991 to 2,240 in 2000. As a result, SEC has been forced to become selective in its enforcement activities and has experienced an increase in the time required to complete certain enforcement investigations. In addition, SEC has been experiencing a staffing crisis that has left it with a large number of less experienced staff. For example, from 1998 to 2000 over 1,000 employees, or about one-third of all staff, left SEC, and in 2000 its overall turnover rate averaged 15 percent—more than twice the rate for comparable positions governmentwide. SEC's Division of Enforcement has, likewise, had substantial turnover, with 89 professional staff leaving the division during

[5]The process of imposing and enforcing court-ordered disgorgement is detailed in appendix II of GAO/GGD-94-188.

[6]U.S. General Accounting Office, *SEC Operations: Increased Workload Creates Challenges*, GAO-02-302 (Washington, D.C.: Mar. 5, 2002) and *Securities and Exchange Commission: Human Capital Challenges Require Management Attention*, GAO-01-947 (Washington, D.C.: Sept. 17, 2001).

2000 and 2001, which was about 16 percent of the 553 staff in the division in 2001.

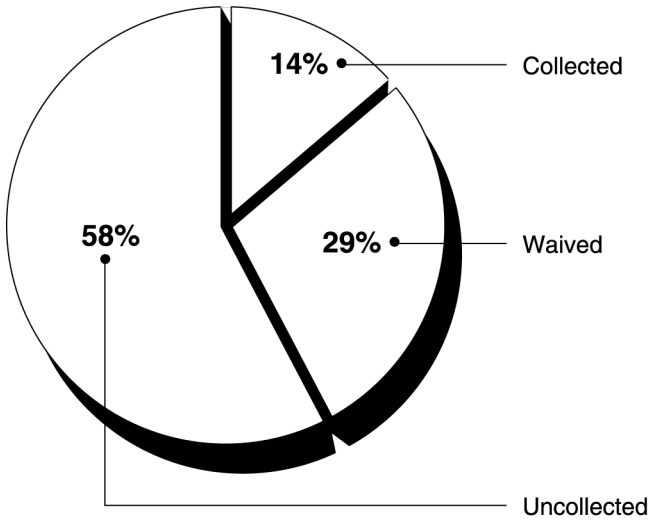
SEC's Reported Collection Rate Is Not an Effective Measure of SEC's Collection Efforts

SEC's current collection rate is limited as a measure of the effectiveness of SEC's collection program for several reasons. First, although its collection rate appeared to decline from prior periods, we found that SEC's varying success in collecting large individual disgorgement orders caused the rate to differ significantly over time. Second, we found that weaknesses in the processes SEC staff used to enter and update the Disgorgement Payment Tracking System (DPTS), which tracks SEC's disgorgement collections, have created errors that prevented us from determining the actual disgorgement collection rate. Finally, the collection rate is less useful to measure SEC's program because factors beyond SEC's control reduce the likelihood that the agency will be able to collect all disgorgement ordered.

SEC Data Show That a Large Amount of Disgorgement Is Not Collected, but the Collection Rate Varied Widely

As recommended in our 1994 report, SEC now collects aggregate data on the amount of disgorgement ordered, waived, and collected. Our analysis of SEC data found that, as of November 2001, SEC apparently had collected approximately $424 million, or 14 percent, of the $3.1 billion in disgorgement that was ordered from 1995 through 2001 (fig. 1).

Figure 1: Percent of Disgorgement Reported as Waived and Collected by SEC, 1995-2001



Note: Collection data are current as of November 16, 2001.

Source: GAO analysis of SEC data.

However, our analysis also found that SEC's collection rate varied over time and was heavily influenced by large individual disgorgement orders. According to SEC data, the disgorgement collection rate varied greatly from year to year. SEC data show that between 1990 and 1999 SEC was able to collect between 2 and 84 percent of the disgorgement amounts owed, not including amounts waived (fig. 2).

Figure 2: Percent of Disgorgement SEC Reported Collecting in the 2 Years After the Orders Were Issued

Note: We calculated the collection rate for each fiscal year by totaling any collections made on disgorgement ordered during each year. To ensure that the amount of time for collection was comparable for each of these years, we totaled the amount of disgorgement collected within a 2-year period following the date of each individual order.

Source: GAO analysis of SEC data.

An analysis of these collection rates shows that SEC's success in collecting large individual disgorgement orders can greatly influence the collection rate. For example, figure 2 shows that in 1990 SEC collected approximately 75 percent of the disgorgement ordered (not including waived amounts) in the 2 years after the orders were issued but only 17 percent of the disgorgement ordered in 1991. However, our analysis found that approximately $400 million of the $427 million collected on disgorgement ordered in 1990 came from a single payment made by one violator. Excluding this case, the reported collection rate for 1990 would have been approximately 15 percent. Similarly, SEC's reported collection rate of 84 percent for 1994 included a disgorgement order of $939 million for a single violator, the majority of which was collected in the 2 years following the order. Excluding this single case, the collection rate for 1994 would have been 23 percent.

Similarly, comparing the overall 14 percent collection rate for 1995 to 2001 to the rate we reported in 1994 also is not meaningful as a result of the impact of these large cases. In our 1994 report, we calculated that SEC had collected 50 percent of the $2 billion of disgorgement ordered from 1987 to April 1994. However, if the $400 million 1990 case cited above is excluded from the collection rate for 1987 to 1994, the rate for that period would have been about 38 percent. As a result of the impact that just a few cases can have on SEC's collection rate, using this rate as a measure of changes in the overall effectiveness of SEC's collection efforts can be misleading.

Data Entry and Update Procedures Have Not Ensured Accurate or Current Information

Another reason that we were unable to use SEC's reported collection rate as a measure of SEC's collection efforts is that the data used to calculate that rate are unreliable. According to standards issued by GAO,[7] appropriate internal controls are necessary to ensure that data are accurate and complete. In addition, data about events should be promptly recorded so that they maintain their relevance and value to management. However, weaknesses in SEC's procedures have resulted in unreliable data in its disgorgement database. As part of our review, we selected a sample of 57 cases and compared information from SEC case files and other documents to entries in DPTS. We found that 18 cases, or approximately 32 percent, contained at least one error in the amount ordered, waived, or collected, or in the status of the case or of the individual violators. Overall, for the 57 cases that we reviewed, DPTS data showed that SEC had collected around $25 million, or approximately 4 percent of the $597 million in disgorgement ordered, not including amounts waived. However, after correcting for the inaccuracies we identified in our review, we found that SEC had actually collected around $55 million, or approximately 11 percent of the disgorgement ordered, not including the amounts waived. Because we judgmentally selected the cases we reviewed, this error rate cannot be projected beyond our sample.

SEC's process for entering data on disgorgement orders into DPTS did not ensure the accuracy or completeness of that data. We found that the sources used as a basis for entering data into DPTS did not always provide

[7]GAO issues standards for internal control in the federal government as required by 31 U.S.C. 3512. These standards provide the overall framework for establishing and maintaining internal controls and for identifying and addressing major performance challenges. See U.S. General Accounting Office, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1999).

the most accurate information. SEC staff in the Office of the Secretary who entered the data into DPTS relied heavily on SEC litigation releases that, according to the staff, may not contain all the details of a disgorgement order. The staff also told us that they do not independently verify the information in the litigation releases. Further, the staff told us that the payment dates recorded in DPTS might not be accurate, because staff used the day entry was made as the payment date if no other date was specified. Finally, we found that it was awkward for staff to accurately record information for individual violators when disgorgement orders were issued to multiple violators.[8] In these instances, payments made by one violator may subsequently reduce the amount all the violators owe. However, the DPTS system does not provide a way to easily enter and track the amounts owed under joint and several liability cases. Instead, staff input the total amount of the disgorgement judgment under one violator and enter a $0 balance for the others, with a notation indicating that each violator is jointly and severally liable with other violators. Payments are recorded under the name of the selected violator, not necessarily the violator making the payment, and a note is made in the system as to which violator had paid. SEC staff said that they entered the data in this way to avoid overstating the amount of disgorgement ordered and paid. SEC officials told us that they will revise their procedures for entering information in cases with joint and several liability in order to more clearly present information related to individual violators.

Of the cases we reviewed, five contained errors that appeared to result from the use of incomplete or inaccurate information as a source of data for DPTS. For instance, in one case with a disgorgement order of over $300,000, the entire disgorgement amount was waived at the same time the disgorgement was ordered in October 1997. But as of November 2001, DPTS did not show that any amount had been waived. In another case involving 10 violators, the attorney responsible for the case told us that 9 of the violators were jointly and severally liable for a disgorgement order of around $800,000. However, several litigation releases contained information on some, but not all, of the violators. As a result, a disgorgement order amount was recorded for one violator from each

[8]Courts sometimes make more than one violator jointly and severally liable for the entire amount in the disgorgement order. In such cases, payments by one or more violators reduce the total amount owed by all violators, and if one violator pays the entire amount, the order would be considered satisfied for all violators.

litigation release, resulting in an overstatement of the total amount of disgorgement ordered by approximately $1.6 million, or about 200 percent.

We also found that SEC's process for updating the information in DPTS may result in the information not being current. SEC's Office of the Secretary sends out a report with the details of each case three times a year and asks that responsible SEC staff correct any inaccuracies and update the information. However, the staff who send out the report said that they have no assurance that each office has carefully reviewed the report and noted that some offices have not been timely in returning their reports. Thus the time lag in entering information into DPTS can be about 4 or 5 months, and the information in DPTS may not be current.[9]

Of the cases we reviewed, 14 contained errors that appeared to be caused by information not being updated in a timely manner. For example, in one case with a disgorgement order of around $18 million, court documents showed that as of late 1999, over $3 million had been collected and distributed to investors. However, as of November 2001, DPTS did not show that any money had been collected. In another case, a disgorgement order of over $5 million was discharged as part of bankruptcy proceedings in 1998, but this fact was not recorded in DPTS until at least October 2001.

Without reliable data that is accurate and up to date, SEC management is limited in its ability to assess its collection program—for instance, in its efforts to determine the reasonableness of the amount of disgorgement waived or collected in individual cases or the overall effectiveness of its collection program. In addition, SEC cannot provide Congress with accurate statistics related to its disgorgement collection activities.

Factors Beyond SEC's Control Make It Unlikely That SEC Will Collect All Disgorgement

Another limitation in the adequacy of the collection rate as a measure of the effectiveness of SEC's disgorgement collection efforts is that factors beyond SEC's control limit its ability to collect the full amount of disgorgement ordered in some cases. Disgorgement orders are based on all the funds obtained through violations and do not take into account the

[9]The timeliness of the data contained in DPTS has been an issue since at least 1991 when SEC's Inspector General noted similar problems and recommended that procedures be developed to ensure that the data are current.

violators' ability to pay.[10] That is, the amount of disgorgement ordered represents the amount of illegal profits or misappropriated funds rather than the amount the violator might be able to pay. For example, in one case we reviewed, SEC obtained a disgorgement order for around $670,000, even though at the time of the order SEC knew the violator did not have any assets. SEC did not collect any money from the violator. According to SEC officials, although SEC may not collect the entire amount of disgorgement ordered in such cases, disgorgement can be a deterrent to future violations and limit the violator's ability to raise funds to engage in new frauds.

This contrasts with the way SEC seeks fines against violators of securities laws. When seeking fines, SEC can take into account a violator's ability to pay or other factors such as the severity of the violation and the degree to which the violator cooperates with SEC. For example, the court can state that a fine is merited but not levy any amount based on the violator's lack of ability to pay. According to SEC officials, the fact that fines are assessed this way is one reason why SEC's collection rate is significantly higher for fines than for disgorgement; in a recent report, GAO calculated the collection rate for fines at approximately 91 percent.[11] SEC officials also said that they are more successful in collecting fines than disgorgements for at least two other reasons. First, disgorgement orders are often much higher than fines, and the larger amounts are more difficult to collect. Second, many violators fined by SEC are current members of the securities industry and are motivated to pay their fines in order to maintain their reputation within the industry. But many of the violators who are ordered to pay large disgorgement orders are either not members of the securities industry or have no desire to remain so.

Securities law violators can lack the ability to pay for a variety of reasons. In many cases, for instance, violators have few or no assets left and may have used the proceeds of their illegal activity on nonrecoverable expenses. For example, in 21 of 37 cases we reviewed in which violators

[10]In a recent report, we noted that the Department of Justice faces a similar situation in collecting criminal restitution, which is assessed without consideration of the criminal's ability to pay. See U.S. General Accounting Office, *Criminal Debt: Oversight and Actions Needed to Address Deficiencies in Collection Processes*, GAO-01-664 (Washington, D.C.: July 16, 2001).

[11]U.S. General Accounting Office, *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).

did not pay all the disgorgement ordered, SEC staff said that disgorgement was not collected because the violators had already spent the money on personal or business expenses that SEC could not recover. In one case we reviewed, the violator had spent $175,000 on custom-made furniture, which the case's court-appointed receiver was able to sell for only about 10 percent of its original cost. In addition, disgorgement orders may be obtained against defunct companies. In two of the cases we reviewed, disgorgement orders were obtained against shell companies, one for $1.6 million and one for $1.5 million. In each case, SEC staff knew that the company was defunct and most likely did not have any assets but obtained the disgorgement order to prevent the company from becoming involved in future fraudulent activities. Further, a violator's assets may already have been used to pay other judgments, leaving little for SEC to collect. In one case involving a disgorgement judgment of $147 million, all the violator's assets—around $40 million—were used to pay investors through private class action claims in a Securities Investor Protection Act case and a Chapter 11 bankruptcy case.[12]

Another reason that violators can lack the ability to pay is that they have little earning capacity. In some cases, violators may be unable to satisfy their disgorgement debt because they declare bankruptcy or are incarcerated. For example, for the period 1995 through 2000 at least 5 of the 10 violators with the largest disgorgement orders were incarcerated because of their fraudulent activities. Also, violators may be defunct companies with no prospects for future income. For example, the two shell companies in the example noted above were defunct at the time of the disgorgement judgment and had no prospects for future operations or income. In other cases, violators may have been banned from further participation in the securities industry, depriving them of their source of income. According to SEC staff, in many cases in which a violator has been ordered to pay disgorgement, SEC also bars the violator from working in the securities industry.

[12]In bankruptcy proceedings, disgorgement is treated as unsecured debt, which is paid after any secured debts are satisfied.

SEC Lacks Strategic Guidance, Clear Policies and Procedures, and an Effective Monitoring Mechanism for the Disgorgement Collection Process

Although disgorgement is intended to help deter fraud by forcing violators of the securities laws to return illegal profits, we found weaknesses in SEC's disgorgement collection program. First, SEC lacks clearly defined strategic objectives and measurable goals for its collection program. SEC's strategic and annual performance plans, prepared under the Government Performance and Results Act (GPRA),[13] do not address the importance of disgorgement collections or provide measures that would help SEC management monitor its staff's collection efforts. Without such guidance and measures, competing priorities and increasing workload could prevent SEC staff from pursuing collection activities to the degree desired by the agency. Second, SEC lacks the specific policies and procedures that would help maximize collection by ensuring that all appropriate actions are taken to collect disgorgement—for example, the types of collection actions staff should take and the timing of specific actions. Third, SEC does not have systems with accurate or complete information for monitoring whether staff are taking appropriate, prompt collection and distribution actions.

SEC Has Not Strategically Addressed Disgorgement Collection Priority In Light of Competing Priorities and Increased Workload

Although its staff consider disgorgement collection to be an important means of deterring fraud, SEC had not clearly defined the priority that should be placed on disgorgement collection or established performance measures to monitor collection efforts. Currently, SEC Division of Enforcement staff must balance their disgorgement collection efforts with various other priorities and a workload that in recent years has been increasing faster than their resources. SEC has begun some efforts to assess alternatives means of reducing the conflicting demands on its staff, such as by contracting out collections or taking other actions, but these assessments have not been completed.

SEC Strategic Plans Do Not Address Disgorgement Priority or Provide Effectiveness Measures

Under GPRA, federal agencies are held accountable for achieving program results and are required to clarify their mission, set program goals, and measure their performance in achieving those goals. According to the Office of Management and Budget and GAO guidance related to GPRA, effectively achieving program results requires each agency to create a

[13]U.S. General Accounting Office, *Managing for Results: The Statutory Framework for Performance-Based Management and Accountability*, GAO/GGD/AIMD-98-52 (Washington, D.C.: Jan. 28, 1998).

strategic plan that articulates the agency's mission and includes long-term goals. [14] To supplement the overall strategic plan, agencies are also required to prepare annual performance plans that specify goals and measures and that describe strategies to achieve results. Such goals and measures help managers determine whether the agency's programs are achieving desired results.

According to SEC's strategic and annual performance plans, deterring fraud is an important part of protecting investors. SEC officials told us that disgorgement is an effective deterrent because it deprives violators of their illegal profits. However, SEC's strategic and annual plans do not clarify the priority disgorgement collection should have in relation to SEC's other goals. In addition, the plans do not establish performance measures for disgorgement collection. According to GPRA, agencies also are to establish performance indicators that can be used to measure or assess the relevant outputs, service levels, and outcomes of each program activity.[15] SEC has not created the measures needed to assess the effectiveness of its disgorgement collection program or its deterrent effect. Such measures could include the percentage of disgorgement funds returned to investors, the timeliness of collection actions, or the number of violators ordered to pay disgorgement who go on to commit other violations.

SEC's Competing Priorities and Increasing Workload Create the Risk That Staff Cannot Make Sufficient Collection Efforts

Without a well-defined strategy that clearly communicates the role and relevance of disgorgement in relation to SEC's other goals—and without performance measures that assess the effectiveness of collection activities—the competing priorities and increasing workload faced by SEC staff create the risk that those staff will not be able to pursue collection activities to the level desired by the agency. The staff in SEC's Division of Enforcement responsible for collecting disgorgement amounts have multiple additional responsibilities. Depending on the office to which they are assigned, they might also investigate potential violations of the securities laws, recommend SEC action when violations are found, prosecute SEC's civil suits, negotiate settlements, and conduct collection activities for fines SEC levies.

[14]See Office of Management and Budget, *Circular No. A-11, Part 2: Overview of Strategic Plans, Annual Performance Plans, and Annual Program Performance Reports* (Washington, D.C.: Nov. 18, 2001) and U.S. General Accounting Office, *Agency Performance Plans: Examples of Practices That Can Improve Usefulness to Decisionmakers*, GAO/GGD/AIMD-99-69 (Washington, D.C.: Feb. 26, 1999).

[15]GAO/GGD/AIMD-98-52.

SEC staff told us that the agency's limited resources force them to choose between the competing priorities of collecting disgorgement and taking direct action to stop ongoing fraud, and that they choose to devote more effort to stopping fraud than to collections. Similarly, SEC officials said that if a large, complex case requires SEC's immediate attention, the agency shifts its resources to focus on that case. In such situations, collection actions on other cases are a secondary priority. As a result, a risk exists that SEC staff will not be able to pursue collection activities to the degree desired by the agency. SEC officials and staff also told us that, in most cases, investors are best served if the agency concentrates more of its resources on stopping ongoing fraud than on collecting disgorgement, because stopping ongoing fraud keeps investors from losing more money. Similarly, a former director of the Division of Enforcement stated that SEC's primary responsibility is investor protection, not collecting all the money from fines and disgorgement.

SEC Is Considering Actions to Address the Competing Priorities Faced by Its Staff

SEC is considering some actions to help address the challenges it faces in ensuring that staff have enough time to collect disgorgement but has yet to finalize any plans. For example, SEC is exploring contracting out a portion of its collection work to private collection agencies. Officials from the National Association of Securities Dealers Regulation, Inc., which began contracting out its collection activities in June 2001, told us that they saw contracting out as a way to help ensure that effective collection actions are taken. Contracting out allows the National Association of Securities Dealers Regulation, Inc. to use its resources to hire litigators and investigators rather than collection attorneys.[16] Using external organizations to conduct collection activities would help alleviate the problem of competing priorities facing SEC staff and allow them to focus primarily on stopping ongoing fraud. As of the time of this report, SEC officials told us that they had spoken with several private collection agencies and were in the process of examining the legal issues involved with delegating some collection responsibilities to these agencies.

Another step SEC has considered is increasing the number of staff dedicated to collection activities. In 1999, SEC created a position for an attorney dedicated to collections. This attorney and one paralegal are the only Division of Enforcement staff devoted solely to collection activities. SEC officials told us that they would like to expand the number of staff

[16]The National Association of Securities Dealers Regulation, Inc. did not yet have enough experience with the contracting effort to evaluate its success.

devoted exclusively to collections but added that they did not feel they could do so because they could not afford to take resources away from other areas.

A recent initiative by SEC's Chairman and commissioners may also affect how staff balance their priorities. In November 2001, SEC announced an initiative called real-time enforcement,[17] which is intended to provide quicker and more effective protection for investors and better oversight for the markets with SEC's limited enforcement resources. To achieve this, SEC intends to take action sooner than it has in the past. For example, the agency plans to

- obtain emergency relief in federal court to stop illegal conduct more expeditiously;
- file enforcement actions more quickly, thereby compelling disclosure of questionable conduct so that the public can make informed investment decisions; and
- impose swifter and more serious sanctions on those who commit egregious frauds, repeatedly abuse investor trust, or attempt to impede SEC's investigatory processes.

Such prompt enforcement action may help SEC collect a greater amount of disgorgement by preventing violators from spending or hiding their assets. However, SEC officials also told us that such actions require significant staff resources, and may reduce the amount of resources that can be devoted to collection actions in other cases or later on in the same case.

SEC's Lack of Clear Collection Policies and Procedures Hinders Management Oversight of Staff Collection Activities

SEC's overall disgorgement collection program lacks clear policies and procedures that specify the actions that staff could take to collect disgorgement. According to federal internal control standards,[18] policies and procedures should be designed to help ensure that management's directives are carried out. During the period covered by our review, SEC did not have in place such policies and procedures for disgorgement

[17]The SEC Chairman announced this initiative in a November 8, 2001 speech at the Practicing Law Institute's 33rd Annual Institute on Securities Regulation.

[18]See GAO/AIMD-00-21.3.1.

collections. Instead, the lead attorneys on the individual cases determined what actions should be taken, with supervisors reviewing the decisions. Supervisors told us that they met periodically with the lead attorneys to review the collection activities already taken and to determine whether further actions were needed.

However, SEC management cannot readily determine whether staff take appropriate collection actions in all cases without clear collection procedures outlining which actions should be taken and when. SEC staff can take a wide range of collection actions, depending on the facts and circumstance of the case. For example, they can file a contempt action, seek to obtain liens on a violator's property, or seek to have a violator's wages garnished. Our review of the actions taken in individual cases reflected such a range of actions. In some cases, we could not determine what actions had been taken, because staff had left the agency or actions were not documented in the files we reviewed. In these cases, we relied on current staff to tell us what actions had been taken. Although collection actions must be tailored to individual cases, having clear guidance on the actions suited to different developments in a case would assist SEC management in ensuring that sufficient and appropriate efforts are made. This type of consistency is particularly important given SEC's relatively high staff turnover rate.

Collection policies that specify the timing and frequency of actions would also assist SEC management in establishing clear expectations on how the program should be managed. For example, we identified two cases in which certain collection and distribution actions appeared to have been delayed. In one case, the violator made the final payment in April 2000, but as of February 2002 a plan to distribute the assets had not been finalized. SEC staff on the case cited internal disagreement and staff turnover as reasons for the delay. In another case, little action was taken for about 14 months, during which time a new attorney was assigned to the case. The new attorney then unsuccessfully filed for contempt for nonpayment, but another 16 months elapsed with little activity. SEC ultimately transferred the case to the Treasury Department's Financial Management Service without collecting any money. The lack of guidance that specifies when to pursue certain collection actions, and how often, affects staff as well as management, since staff are not held accountable to any clear standards. And SEC management cannot determine whether staff take all collection actions promptly, which increases the risk that staff could miss opportunities to maximize collections.

SEC officials agreed that such guidance is needed, and in June 2002 provided us with draft collection guidelines that they plan to implement by the end of July 2002. The draft guidelines detail the types of actions that should be considered and give specific timeframes for their completion. If implemented, the guidelines would address the concerns noted above. At the time of our review, SEC had not finalized a means for ensuring that staff comply with the guidelines, such as a checklist that could be placed in each case file indicating the actions taken, how frequently, and why.

SEC Management Does Not Have a System to Monitor Disgorgement Collections

At the time of our review, SEC did not have in place a system that would allow management to monitor activities to ensure that all appropriate actions are promptly taken. According to federal internal control standards, internal controls should assure not only that ongoing monitoring is a part of normal operations but also that it assesses the quality of performance over time. In our 1994 report, we recommended that SEC enhance DPTS to include aggregate and individual information on disgorgement cases. SEC's current system for tracking disgorgement case information does not provide the accurate data SEC managers need to monitor collection efforts and identify cases that require their intervention.

We also found that SEC was not using a monitoring system to oversee the distribution of disgorgement collected. In our 1994 report, we recommended that DPTS include the amounts of disgorgement distributed and the recipients. Currently, information on disgorgement funds available for distribution to investors is maintained in case files that are manually maintained and, therefore, cannot be easily analyzed or aggregated. SEC officials told us that aggregating this information would not help them collect or distribute funds. But because SEC cannot easily aggregate information on the distribution of funds, SEC staff could not tell us how much of the disgorgement collected was paid to investors or to the Treasury. As a result, neither SEC nor we could tell to what extent the disgorgement program was returning funds to harmed investors.

Relying on individual SEC staff or their supervisors to monitor distribution efforts is not always adequate. Of the 18 cases we reviewed in which disgorgement had been collected in full, we found two cases in which the disgorgement collected had not been promptly distributed. In one case, the violator's final disgorgement order payment occurred in July 2001, but as of March 2002, the funds had not been distributed, and SEC staff were still in the process of obtaining bids from potential receiver candidates. The attorney in charge attributed this 9-month delay to his heavy workload and

trial responsibilities. In another case, approximately $100,000 collected through criminal restitution was transferred to SEC's Office of the Comptroller and was to be distributed by the court-appointed receiver. However, SEC staff responsible for the case did not realize that the Office of the Comptroller had received the funds from the criminal restitution action until the case was examined in preparation for our review. As a result, this amount was not included in the final distribution made by the receiver. SEC staff responsible for the case stated that this was an oversight on the part of both the receiver and SEC. However, they also noted that the case was unusual in that the judge had required SEC to oversee not only disgorgement funds from SEC's case but also restitution funds recovered as a result of the criminal case.

Without reliable, accessible data, SEC is limited in its ability to monitor whether collection activity is taking place and whether collected funds are promptly distributed. More importantly, without using a system to manage the program, SEC management is unable to assess the extent to which its staff are returning funds to defrauded investors.

SEC Has Improved Its Process for Selecting and Monitoring Receivers but Does Not Have a Central Monitoring System

SEC has improved its process for selecting individuals to recommend as court-appointed receivers. In addition, although SEC is not responsible for supervising receivers, its staff are taking actions to monitor the cases that have receivers. However, SEC still lacks a mechanism for tracking information such as the fees receivers charge and the amounts they collect, limiting management's ability to ensure that as much money as is reasonably possible is returned to harmed investors.

SEC Has Improved Its Process for Selecting Individuals to Recommend As Receivers

Receivers are used on SEC's cases to perform tasks such as gathering and liquidating violators' assets and distributing funds to harmed investors. SEC usually selects a candidate and then recommends the individual for receivership to the court for final approval. According to an SEC official, some courts accept SEC's recommended receiver, but other courts prefer to appoint a receiver on their own. Because the court appoints the receivers and ultimately defines their duties, receivers are answerable to the judge of the court rather than to SEC.

As court-appointed fiduciaries, receivers are subject to the same standards of trust and confidence as other fiduciaries, and need to be selected as

impartially as possible.[19] In 1994, we examined whether SEC had procedures and management controls for selecting receivers in response to concerns that former SEC employees were favored in the receiver selection process. We reported that SEC had no formal policies or qualifying standards in place to ensure that receivers were selected impartially, and we were unable to determine how many receivers were former SEC employees.

As we recommended, SEC implemented guidelines in July 2001 for selecting candidates for receiverships that appear to address the concerns raised in our 1994 report. The guidelines have shifted responsibility for choosing receivers from the SEC attorneys themselves to a committee of higher-level managers. When receivers are needed, SEC must now obtain written proposals from at least three candidates detailing the applicants' experience, fees, and staffing and operational plans. The candidates' proposals are then submitted to a three-person committee for final evaluation and selection. The committee is composed of the chief or deputy chief litigation counsel; the investigating or litigating attorney on the case; and an associate director, regional director, or district administrator.

SEC has also formalized criteria to use when evaluating candidates' proposals. These criteria include costs and the candidate's reputation, experience in securities regulations, and past service as a receiver on another SEC matter. The guidelines state that the committee should avoid selecting the same person repeatedly for appointments as a receiver, so as to avoid the appearance of favoritism. The committee must also justify its selection in writing. The names of receivers selected are entered into a database that can be used to identify receiver candidates on short notice.

We reviewed 10 recent receiver recommendations and found that SEC was generally following the guidelines for selecting receivers. In every case we reviewed, the three-person committee had evaluated at least three candidates and documented the reasons for its selection. In addition, all the cases contained summary information on the candidates' backgrounds, and nine cases contained fee information from at least two candidates. We found that most of the individuals selected as receivers—7 of the 10 selected—were not former SEC employees. In cases in which SEC had

[19]A fiduciary must act with the same degree of care and skill that a reasonably prudent person would use in connection with his or her own affairs.

recommended former employees, documentation was provided justifying the nominations. In two such cases, SEC recommended former employees because they had the most experience relevant to the job. In one case, we could not tell whether the candidate was a former SEC employee, but SEC documented the candidate's extensive relevant experience.

SEC Does Not Directly Supervise Receivers but Does Monitor Their Activities

SEC assists the court in monitoring receivers, helping to ensure that they adhere to their responsibilities as court-appointed fiduciaries tasked with protecting recovered funds and complying with court orders. In our 1994 report, we found that SEC did not have adequate oversight over receivers, and we could not tell whether SEC staff were adequately reviewing receiver fee applications. We recommended that SEC establish guidelines for monitoring court-appointed receivers.

Although SEC still has not established such guidelines, we found that it has taken steps to monitor receivers' actions. Staff in SEC's Division of Enforcement told us that they monitor court-appointed receivers by working closely with them and by asking them to consult with SEC before taking any major actions, such as seizing or selling assets. In one case we reviewed, we saw documentation of phone conversations between SEC and the receiver concerning the receiver's distribution plan and case status. In another case, we saw correspondence from the receiver regarding the progress made and the results of disposed assets. We also spoke with three receivers who work on SEC cases and it appeared that SEC was working closely with them to monitor their actions. One receiver we spoke with said that he regularly interacts with SEC while working on a case in order to avoid disputes about his handling of the case and fees. He added that disputes over how he handles a case could cost his firm time and money that are often not reimbursable under the receivership. Another receiver we spoke with said that while working on an SEC case, he is in frequent communication with the SEC attorney on the case, whom he found to be available, responsive, aggressive, and concerned about the progress of cases.

We also found that SEC staff had reviewed the receiver fee applications and obtained additional information needed to assess the application. Reviewing the applications serves as an important control for ensuring that as much money as possible is returned to investors, as receivers are compensated for their services from the amounts collected in the case. Although the courts approve receivers' fee applications, SEC attorneys review the applications beforehand and comment on the reasonableness of

the fees. In the absence of guidelines, SEC attorneys use their knowledge of the facts and circumstances of a case to determine whether fees are reasonable. One senior SEC staff member told us that he reviews fee applications by considering the exact tasks the receivers and their staff have performed, assessing the need for specialized staff, and comparing the fees to fees for similar services in the same geographic area. During our review, we saw documentation showing that the attorney in one case had examined the number of staff the receiver hired to complete necessary tasks, assessed the necessity of the tasks, and examined the appropriateness of the receiver's expenses. In the same case, we also saw documentation showing that the attorney had requested and examined information such as record of hours worked in order to assess the reasonableness of the fees. In another case, SEC had noted in a motion filed in support of the receiver's fee application that the receiver apparently was not billing for all the work performed. In a third case, one attorney told us that after monitoring the rising costs of the fee applications, the SEC attorney had taken over some of the receiver's duties, such as preparing a distribution plan, to minimize the receiver's expenses and fees.

SEC Does Not Centrally Monitor Information on Receiver Fees

We found that SEC was not using a centralized system to monitor receiver fees. Receivers are compensated for their services from the amounts collected, so when receivers' fees are high, less money is available for distribution to investors. In our 1994 report, we found that SEC did not track information on receivers, limiting its ability to assess the effectiveness of receivers and to monitor trends in costs. We recommended that SEC collect such information in a centralized management information system. However, SEC staff told us that they do not track this information in DPTS or any other system because it would not help with their collections efforts. Currently, receiver data on the amount recovered, costs and expenditures, and the amount disbursed to investors is accessible through case files that are manually maintained.

However, tracking receiver data through a centralized management information system could improve SEC's oversight of all cases. Managers would be able to identify specific instances in which receivers' fees are high or are absorbing a large share of the funds available for distribution and, if appropriate, take prompt action to minimize these costs. While we found no evidence in the cases we reviewed that receiver fees were excessive, we did find that receivers' fees have sometimes amounted to half or more of the disgorgement funds collected in cases. For example, in one case we reviewed, a receiver appointed to find and liquidate assets

received over $285,000 in fees and expenses—approximately half of the total amount collected. In another case, the fees paid to the receiver exceeded the amount returned to harmed investors. This receiver, who negotiated the sale of oil and gas interests, was paid approximately $11.6 million for his services; the investors received around $10 million. Furthermore, if managers had access to such a centralized system, they would not have to rely solely on the case attorneys for information—a factor that is particularly important given SEC's relatively high turnover rate and resulting loss of experienced staff with knowledge of cases.

SEC Has Taken Steps to Ensure that Disgorgement Waivers Are Appropriate

A report by SEC's Inspector General found that SEC staff were not making sufficient efforts to verify the financial condition of violators seeking waivers of a disgorgement amount. In response, SEC issued new guidelines on the waiver process, and our review of a sample of recent waiver recommendations found that SEC staff were following these guidelines.

SEC's Inspector General Identified Weaknesses in SEC's Waiver Process

According to SEC officials, waivers are a tool SEC can use to more easily reach settlements with violators and thus avoid spending resources on litigation. When violators request a waiver based on an inability to pay, SEC staff are to gather the necessary information to validate this claim and provide to the Commission, which must approve any such waivers, a recommendation to either approve or deny the request.[20] The Commission usually approves waivers at the same time it approves the settlement of the enforcement action, prior to the court's final approval of the disgorgement order. Waivers also must be approved by the court, and in recommending that courts grant waiver requests, SEC must be able to show that it cannot collect the total amount of the court-ordered disgorgement. SEC guidelines also require that waiver recommendations be supported with sworn financial statements and stipulate that depositions and information from third parties can be used for further support. SEC staff must analyze the financial statements to determine whether the information is accurate and complete. SEC generally does not consider waivers when the violator is a recidivist, when SEC believes the violator has withheld information, or when SEC has spent significant resources obtaining a judgment.

[20]SEC has five commissioners, who are appointed by the President to 5-year terms. Among their other responsibilities, the commissioners approve actions that SEC staff seek to bring against violators.

A June 2000 audit by SEC's Inspector General staff found that SEC could improve its process for verifying the accuracy of the violator's claimed lack of ability to pay the entire disgorgement order before recommending that waivers be approved by the Commission. Specifically, the audit identified two problems. First, staff did not verify that the information violators submitted was complete and accurate. Second, the procedures staff used to ensure that they had identified all of the violators' assets were inadequate. For example, SEC staff did not sufficiently utilize online databases to verify the information contained in financial statements or to identify hidden assets. As a result, SEC staff could not offer sufficient assurance that violators had disclosed all of their assets to SEC. To improve SEC's ability to provide such assurance, the Inspector General identified best practices that enforcement staff could use in verifying violators' financial information and recommended that SEC adopt these procedures.

SEC Has Implemented Revised Guidelines, and Staff Are Following Them

In October 2000, SEC implemented guidelines designed to improve the waiver recommendation process. The guidelines require SEC staff to analyze violators' financial statements by reviewing supporting documentation such as bank statements, tax returns, credit reports, and loan statements. In addition, SEC has contracted with a database provider that performs searches for information such as real property and motor vehicle records. SEC officials told us that under the guidelines, supervisors now review waiver recommendations made by their staff and that the Chief Counsel's Office also reviews every waiver recommendation before it is submitted to the commissioners. The officials also told us that, when funds become available, they plan to hire an outside contractor to audit a sample of waiver recommendations in order to ensure that the guidelines are being followed and that the problems identified by SEC's Inspector General have been addressed.

We reviewed a sample of 10 recent waiver recommendations and found that SEC staff were following the revised guidelines. For example, the guidelines describe certain types of situations in which SEC staff should investigate further or request additional information, and we found that SEC staff were taking these actions. In one case we reviewed, the violator owned stock in a company, and enforcement staff on the case requested information on this stock in order to determine its value. In another case, the violator did not initially submit complete information on his financial condition. Enforcement staff questioned him about his sources of income, obtained all relevant loan statements, and verified the value of his personal property, real estate, and business interests. Enforcement staff also were

using database searches to obtain information on violators' assets and financial condition, as the guidelines require. However, not enough time has elapsed since the revised guidelines were put in place to determine their effect on the number or size of waivers recommended by SEC.

Conclusions

Depriving securities law violators of their illegally obtained funds can help SEC achieve its mission of protecting investors and maintaining confidence in the fairness and integrity of the U.S. securities markets. Although we acknowledge that the collection rate is not likely the best measure for assessing the effectiveness of SEC's disgorgement collection activities, improving the process for entering and updating the information in DPTS would provide accurate and current information for SEC to use to monitor progress on individual cases. Having such information would also allow SEC's management to analyze potential trends in the aggregate data to ensure that any changes in the collection rate can be explained.

Although SEC officials considered disgorgement to be an important tool for sanctioning securities law violators and deterring additional fraud, we identified weaknesses in various elements of SEC's disgorgement collection program. Under GPRA, federal agencies are expected to become more performance oriented by setting goals for program performance and measuring progress toward those goals. However, we found that the strategic and annual performance plans that SEC has prepared under GPRA did not specifically address disgorgement collection or establish performance measures to assess the effectiveness of the agency's disgorgement collection efforts. Because SEC's Division of Enforcement staff already juggle competing priorities and an expanding workload, the lack of strategic guidance and measures against which to assess performance could result in less collection activity being undertaken than SEC management desires. To reconcile the competing demands on its staff, SEC will have to weigh the importance of other enforcement activities relative to disgorgement collection against the concern that disgorgement may lose its effectiveness as a sanction and deterrent to further fraud if collection activities are not attempted. The agency has begun this process as part of considering various alternative means of collecting disgorgement amounts but has yet to complete its assessment and take action to implement any resulting program changes.

Similarly, SEC did not have in place specific policies and procedures that would provide staff with guidance on the type, timing, and frequency of collection actions they should consider and help them understand what is

expected of them. SEC provided us with draft collection guidelines to be implemented by the end of July 2002 that would address these concerns, but has not yet finalized controls to help management ensure that staff follow the guidelines. Without such guidance and controls, SEC management cannot ensure that sufficient and appropriate collection efforts are being made consistently across all cases. Given SEC's relatively high staff turnover rate, a tool to quickly determine what actions have been taken and when could help any staff that assume responsibility for cases with which they lack familiarity. Finally, SEC management did not have reliable, accessible information it could use to ensure that collection activity is taking place and that collected funds are being distributed promptly. With an accurate and current disgorgement tracking system, SEC managers could identify cases that may require attention, such as cases that have had considerable time pass without any collection activity. Furthermore, without an ability to centrally monitor subsequent distribution activities, SEC cannot assess the extent to which it is returning disgorgement funds to harmed investors.

Since our last report, SEC has improved its process for selecting individuals to recommend as receivers, and in the cases we reviewed staff have been taking actions to oversee receivers' efforts. However, SEC still does not track individual case information on receivers' fees and expenses in a central management information system, as we recommended in our 1994 report. Without such a system, SEC managers cannot readily identify cases in which receiver fees have risen to a significant portion of the amount collected and thus could miss the opportunity to take additional actions to ensure that such charges are appropriate and that the maximum amount is returned to harmed investors.

SEC has also taken steps to improve its ability to ensure that disgorgement waivers are recommended only when SEC has verified the violator's inability to pay. Specifically, the agency implemented guidelines designed to provide better assurance that the financial information violators provide is accurate and that all assets have been identified. Based on our review of a sample of recent waiver recommendations, we found that SEC staff were following these guidelines. However, it was too early to determine what effect, if any, these guidelines were having on the number or amount of waivers granted.

Recommendations

To improve SEC's ability to ensure that the disgorgement collection program meets its goal of effectively deterring securities law violations and

returning funds to harmed investors, we recommend the Chairman, SEC, take the following actions:

- Develop appropriate procedures to ensure that information maintained in DPTS is accurate and current.

- Ensure that disgorgement and the collection of disgorgement are addressed in SEC's strategic and annual performance plans, including the development of appropriate performance measures.

- Expeditiously complete the evaluation of options for addressing the competing priorities and increasing workload faced by SEC's Division of Enforcement staff, including assessing the feasibility of contracting certain collection functions and increasing the number of staff devoted exclusively to collections, and take steps to implement any recommended actions.

- 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. In addition, SEC should develop controls to ensure that staff follow these guidelines.

- 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, including the reasonableness of receiver fees.

Agency Comments and Our Evaluation

SEC officials provided written comments on a draft of this report that are reprinted in appendix II. In general, SEC agreed with most of the report's findings, conclusions, and recommendations. As detailed in the written comments, SEC is taking or planning to take action to implement most of our recommendations. SEC officials also provided technical comments, which we have incorporated as appropriate.

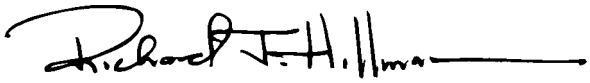
In response to our recommendation to monitor the distribution of disgorgement, including fees paid to receivers, SEC officials said that the agency plans on implementing a system to monitor when courts enter distribution plans and when receivers distribute funds. However, as stated in its letter, SEC does not believe that aggregating information on distributions of disgorgement and receiver fees would help the agency

assess how well it is meeting its goal of deterring fraud and depriving wrongdoers of their ill-gotten gains. SEC noted that the amount distributed to investors is a function of numerous factors that vary from case to case, including the size of the disgorgement award, how much the agency could collect, and the costs of administering the receivership. We agree that aggregate statistics on the amount of disgorgement distributed to investors and the fees paid to receivers may have limitations as measures of SEC's performance in these areas. However, in addition to depriving violators of their illegally obtained funds, returning money to harmed investors is an important element of the disgorgement program. Knowing the total amount of funds returned to investors every year would provide SEC with an important means of documenting the impact of its efforts in this area. Reviewing such information over time would also help SEC focus on ensuring that harmed investors receive the maximum, reasonable amount of funds.

Another focus of our recommendation was to ensure that SEC management had an effective means for monitoring the fees paid to receivers in order to determine whether they are reasonable. While we recognize that receivership fees are within the purview of the court, SEC does have opportunity to object to those fees if they appear unreasonable. In addition, while we also recognize that the facts and circumstances of each individual case must be considered when making such determinations, a system that allows management to monitor cases across the Division of Enforcement can be a useful tool for identifying cases for further review. We believe that the system SEC plans to implement for monitoring the distribution of disgorgement can also be used for this purpose and would likely require only minimal additional resources.

As agreed with your offices, 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 send copies of this report to the Chairman and Ranking Minority Members of the Senate Committee on Banking, Housing, and Urban Affairs and its Subcommittee on Securities and Investment; the Chairman, House Committee on Energy and Commerce; the Chairman of the House Committee on Financial Services and its Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises; and other interested congressional committees. We also will send copies to the Chairman of SEC and 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 regarding this report, please contact me or Cody J. Goebel at (202) 512-8678. Additional GAO contacts and acknowledgements are listed in appendix III.



Richard J. Hillman
Director, Financial Markets and
Community Investment

Scope and Methodology

To determine SEC's collection rate, we obtained and analyzed a copy of SEC's database, as of November 16, 2001, containing all disgorgement orders ever entered into the database. Using this information, we calculated a single collection rate for all orders issued in fiscal years 1995 through 2001. We calculated a collection rate on disgorgement ordered for each fiscal year from 1989 to 1999. To ensure that the amount of time for collection was comparable in each of these years, we totaled the amount of disgorgement collected within a 2-year period following the date of each individual order.

We also assessed the reliability of the database by comparing data on the amounts and dates of the disgorgement orders, waived amounts, and payment amounts in the database to information in the case files for 57 judgmentally selected disgorgement orders. These 57 cases included a judgmentally selected sample of 35 cases with full, partial, and no payments; 10 cases with waivers; and 2 cases used to pre-test our data collection instrument. We selected these cases based on a printout from DPTS to ensure that we reviewed cases with a variety of characteristics, such as whether collections had been successful and whether a receiver had been appointed. We confined our sample to civil cases with disgorgement ordered from fiscal years 1998 through 2000 from the SEC Chicago, Los Angeles, and Washington, D.C., offices, and we visited these offices to review the files maintained there and to discuss the cases with attorneys who had worked on them, whenever possible. Finally, we also reviewed the 10 case files with the largest disgorgement amounts ordered from fiscal years 1995 until 2000 because these represented about 24 percent of the total dollar amount of disgorgement ordered during that period. We compared data on the amounts and dates of the disgorgement orders, waived amounts, and payment amounts. We also interviewed SEC officials knowledgeable about DPTS regarding the purpose of the system, security, data quality controls, and the data entry process. We were unable to determine the extent of the errors in the database because our sample was not representative of all SEC cases.

To determine factors that affect SEC's ability to collect disgorgement, we spoke with officials from SEC, two private collection agencies, and three receivers that had worked on SEC disgorgement cases. In addition, we spoke with officials from other organizations and federal agencies that also conduct collections to learn how the characteristics of SEC's disgorgement debts may have varied from other types of debts. These organizations and agencies included the Commodity Futures Trading Commission, the Department of Education, the Securities Investor Protection Corporation,

and the National Association of Securities Dealers Regulation, Inc. We also used the case files we selected to identify any characteristics that appeared to affect collections and to corroborate the factors described by the officials with whom we spoke.

To assess SEC's disgorgement collection program, we reviewed SEC's strategic and annual plans, its administrative rules of practice regarding disgorgement payments, rules relating to debt collection, and guidelines on distribution. We also discussed the collection and distribution processes with SEC officials from Washington D.C., the Chicago Midwest Regional Office, and the Los Angeles Pacific Regional Office. We also reviewed the judgmentally selected case files to examine collection actions taken after the disgorgement order date. In cases in which collections had occurred, we also used the files to determine what distribution activities had taken place. In instances in which we could not determine what collection actions had been taken or the reasons disgorgement went uncollected, we spoke with SEC attorneys familiar with these cases to learn what collection efforts had been made and what had contributed to any inability to collect the owed amounts. The results of our case file review are not representative of all SEC cases. We also spoke to officials at the National Association of Securities Dealers Regulation, Inc. about their experience with contracting out collection activities.

To evaluate the changes in SEC's process for recommending receivers and monitoring their activities, we reviewed documentation on SEC's policies and procedures for selecting receivers. In addition, we discussed the selection and monitoring activities with officials from the Division of Enforcement, SEC's Office of the General Counsel, and the Chicago and Los Angeles regional offices. We also spoke with three receivers appointed to SEC disgorgement cases to obtain their views on their role, responsibilities, and relationship with SEC officials. Finally, we reviewed a printout from the agency's receiver database and examined 10 recent cases in which a receiver was recommended to assess SEC's compliance with its selection procedures. We also reviewed seven cases in which a receiver had been appointed to determine how SEC monitors receiver activities. We also spoke with SEC attorneys to learn what actions had been taken to monitor receivers and to review receiver fee applications. The results of our case file review are not representative of all SEC disgorgement cases.

To evaluate the improvements in SEC's process for recommending the waiving of disgorgement amounts, we reviewed the SEC Inspector General's January 2001 report and applicable guidelines related to

recommending waivers. We discussed the waiver process with officials from SEC's Division of Enforcement and the SEC Inspector General's Office. In addition, we conducted a case file review of 10 cases with partial and full waivers and a final judgment ordered in fiscal year 2001. We judgmentally selected between two to four disgorgement cases from the SEC Chicago, Los Angeles, and Washington, D.C., offices. The results of our case file review are not representative of all SEC cases. In addition, our office of investigation conducted an asset search on one waiver case to confirm that the defendant had no means to pay and that the waiver was justified.

We conducted our work at the SEC Washington, D.C., headquarters, Chicago Midwest Regional Office, and Los Angeles Pacific Regional Office from August 2001 through July 2002 in accordance with generally accepted government auditing standards.

Comments from the Securities and Exchange Commission

DIVISION OF
ENFORCEMENT

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

July 3, 2002

Mr. Richard J. Hillman
Director
Financial Markets and Community Investment
U.S. General Accounting Office
441 G Street, N.W.
Washington D.C. 20548

Re: Draft Report Entitled "More Actions Needed to Improve Oversight of Disgorgement Cases"

Dear Mr. Hillman:

Thank you for providing us with the opportunity to review and comment on your draft report addressing the Securities and Exchange Commission's collection efforts regarding disgorgement. The report discusses the usefulness of collection rates as a measure of the effectiveness of our disgorgement efforts, assesses our collections program, evaluates the changes in the SEC's process for recommending receivers and evaluates our process for recommending waivers of disgorgement amounts.

As the report points out, we have obtained a number of large judgments for disgorgement knowing that it was unlikely they would ever be paid. We believe that it is important to continue to obtain these judgments, and have them hang over defendants' heads, both for their general and specific deterrent effect and because of the limits they place on these defendants in terms of their ability to raise further capital or to use entities as vehicles for fraud in the future. As a result, however, since many large judgments are uncollectable from the time they are entered and for the other reasons you articulate in your report, the collection rate is not an appropriate measure of our effectiveness as to disgorgement.

We agree with most of your conclusions and recommendations and are already implementing some of the most important recommendations. In sum, we will:

- distribute clearer guidance for our staff on more timely and effective collection efforts,
- develop a new procedure for obtaining updated information on disgorgement amounts ordered and collected,
- seek to develop a performance measure related to disgorgement and collections,
- examine contracting with outside firms to do collection work, and
- implement a system to monitor when courts enter distribution plans and when funds are distributed under those plans.

Our specific comments as to several of the recommendations follow.

I. Ensuring Reliability of Disgorgement Data

The draft report found inaccuracies in the sample of data examined which are largely the results of delays in obtaining updated information concerning actions in Federal Court or payments to a court registry or court appointed receiver. The draft report recommends that the SEC develop procedures to ensure that information in the Disgorgement Penalty Tracking System be current and accurate. We agree with this recommendation and accordingly, we are developing a new procedure for obtaining updated information more rapidly. As an alternative to our existing practice of generating periodic reports for review and update by staff, we have determined to require that the responsible staff must submit to DPTS a Financial Judgment Record Form as soon as they receive notice of any reportable event that pertains to disgorgement. The Form will be made available to all staff electronically and staff will be instructed to submit completed forms via a dedicated e-mail mailbox.

II. Ensuring Disgorgement and Collections are Addressed in Strategic and Performance Plans

The draft report recommends that disgorgement and collections be addressed in the SEC's strategic and annual performance plans. We view judgments for disgorgement and collection of those judgments as important components of our mission of investor protection. We will seek to develop a performance measure related to disgorgement and collections for inclusion in the fiscal 2004 performance plan and the strategic plan when it is next updated. We do not believe that the new performance measure should be the rate at which disgorgement is collected, however. As you point out, the collection rate can be skewed by whether we have a large payment from one defendant in a given year and because the individuals who owe large sums of disgorgement generally have long since spent their ill-gotten proceeds and there is simply no hope that money will be obtained. We will develop a measure based on the timeliness of our collection efforts.

III. Addressing Competing Priorities within the Division of Enforcement

The draft report recommends that we expeditiously complete our current efforts to assess the feasibility of (i) contracting for certain collection functions, and (ii) increasing the number of staff devoted to collection efforts. The report accurately describes the enormous workload and the competing priorities of the staff, including whether to do collection work or to work on stopping new and ongoing frauds. While collections have always been viewed as extremely important, our first priority has been, and we believe should continue to be, to stop ongoing frauds with the aim of protecting investors from additional losses. We have been examining contracting with outside firms to do collection work and will make every effort towards issuing a request for proposals expeditiously.

As to devoting more staff exclusively to collections: we do not currently have the staff to accomplish this goal. There are, however, proposals to increase our staffing levels and we will reexamine our ability to devote more staff exclusively to this effort as our staffing levels increase.

VI. Finalizing Collection Guidelines

The draft report recommends that we establish a specific time frame for developing and implementing collection guidelines. The Division of Enforcement has developed collection guidelines and will implement the guidelines during July 2002. These guidelines address all aspects of your recommendations; they include practice guides to assist the staff in enforcing judgments through litigation, requiring the staff to adhere to certain deadlines and tracking the staff's efforts and results.

V. Monitoring Distributions of Disgorgement

Last, your draft report recommends that we:

> [e]nsure 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, including the reasonableness of receiver fees.

As noted in the draft report, the SEC staff currently monitors the distribution of disgorgement, typically by court appointed receivers, on a case-by-case basis. We plan on implementing a system to monitor when courts enter distribution plans and when receivers (or other distribution agents) distribute funds.

We do not believe that aggregating information on distributions of disgorgement would help the agency assess how well it is meeting its goal of deterring fraud and depriving wrongdoers of their ill-gotten gains. The amount distributed to investors (rather than given to the United States Treasury) is a function of numerous factors that vary from case to case, including the size of the disgorgement award, how much the agency (and the receiver, if one is appointed) could collect, and the costs of administering the receivership, including fees paid to receivers and attorneys and accountants under their direction. In some complex cases, receiver fees and costs will necessarily consume a substantial portion of the disgorged assets. In some simple cases, the fees and costs necessary to distribute the disgorged funds will be minimal. Combining the amounts distributed and the fees paid to receivers in many cases will not shed any light on whether defrauded investors could or should have received more in any particular case or even overall. The only way to determine if the amount returned to investors is appropriate is to evaluate the particular facts and circumstances of the case. Since the receivership fees are totally within the purview of the court in any particular matter, we do not believe that accumulating data

on these fees would be useful in accomplishing our mission of investor protection. We are issuing new guidelines for collections and establishing new systems for tracking collections and distributions. We believe that those measures will greatly improve our ability to monitor the effectiveness of our disgorgement program. In addition, we note that these efforts will be an enormous undertaking with limited staff resources. While we will continually review the effectiveness of these measures, and consider modifications as appropriate, we do not believe that accumulating additional data is realistic or useful at this time.

We appreciate the care and thought that is evident throughout your report and recommendations. If we can be of any further assistance please contact me at (202) 942-4500 or Joan McKown at 942-4530.

Yours truly,

Stephen M. Cutler
Director

GAO Contacts and Staff Acknowledgments

GAO Contacts

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