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Report to the Chairman, Subcommittee on Oversight and Investigations Committee on Energy and Commerce House of Representatives

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SECURITIES ENFORCEMENT

Improvements Needed in SEC Controls Over Disgorgement Cases

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The Honorable John D. Dingell
Chairman, Subcommittee on Oversight
and Investigations
Committee on Energy and Commerce
House of Representatives

Dear Mr. Chairman:

This report responds to your request that we review the Securities and Exchange Commission's (SEC) procedures for the handling and disposition of disgorged funds and whether the individuals appointed to manage the funds are benefitting from prior SEC employment. Funds are disgorged when securities law violators surrender the proceeds obtained from their illicit activities. Courts may order that the funds be distributed to investors harmed as a result of the violation, or when SEC and the courts believe that distributing the funds is not economically practical or efficient, the funds are to be transferred to the U.S. Treasury. When a plan for distributing funds to investors is prepared, the court sometimes appoints a receiver to manage the funds and carry out the terms of the distribution plan.

Since 1990, SEC has had the authority to impose disgorgement in its administrative proceedings. However, our report concentrates on court-ordered disgorgement sanctions.[1] When we began our review in March 1992, SEC had not yet ordered disgorgement in administrative proceedings, nor had it adopted any rules governing disgorgement sanctions imposed by its administrative law judges.[2]

In this report, we address whether SEC has procedures and management controls to (1) assess the effectiveness of its disgorgement collection and distribution efforts, (2) preclude favoritism or minimize any appearance of favoritism in recommending individuals as receivers, and (3) provide adequate oversight of receivers and funds in their possession.

[1]According to federal court and SEC officials, the federal courts have ultimate responsibility for court-ordered disgorgement sanctions. SEC attorneys recommend to the court how much disgorgement to seek and how to enforce the disgorgement order. The presiding judge must approve SEC's recommendations. (See app. II for a description of the process for imposing and enforcing court-ordered disgorgement.) In administrative proceedings, however, SEC is the tribunal and is responsible for disgorgement sanctions ordered by its administrative law judges. The commissioners must approve recommendations made by SEC attorneys on how much disgorgement to seek in administrative proceedings and how to enforce disgorgement ordered in administrative proceedings.

[2]SEC first used its administrative authority to order disgorgement in August 1992. As of April 6, 1994, SEC had ordered disgorgement in administrative proceedings in a total of 11 cases.

Details on our objective, scope, and methodology are described in appendix I. SEC provided written comments on a draft of this report. These comments are presented and evaluated on pages 11 and 12 and are reprinted in appendix III.

Results in Brief

The Federal Managers' Financial Integrity Act of 1982 (Public Law 97-255), enacted to help federal agencies better manage their financial assets and operations, requires that agencies establish adequate management control systems, evaluate them on a continuous basis, and report to Congress on their adequacy. SEC can improve its management control systems for governing its disgorgement efforts. For example, SEC does not track or maintain on an aggregate basis information on disgorgement collected and distributed. Instead, SEC's information is maintained on a case-by-case basis. Tracking this data also on an aggregate basis would make it easier for SEC to assess the overall effectiveness of its disgorgement efforts. Further, SEC does not provide its attorneys formal written policies or procedures to guide them in assisting the federal courts to select individuals as receivers and ensure adequate oversight of receivers' activities and requests for compensation. Without formalizing these policies and procedures SEC cannot adequately ensure that (1) any appearance of favoritism in its receiver recommendations is precluded or (2) funds managed by receivers are safeguarded until disbursed.

Background

The use of the disgorgement sanction in securities law violation cases is a relatively recent phenomenon. Disgorgement was first ordered in a securities law violation case in 1970.[3] In this case, the court ordered the defendants, who profited from inside information, to disgorge their profits for possible distribution to those who suffered losses as a result of the defendants' actions. A widely publicized case of court-ordered disgorgement was the $400 million disgorgement order in November 1990 against Michael Milken for, among other things, insider trading, stock manipulation, and failure to make required disclosures of beneficial ownership of securities. Another case resulted in the imposition of a $52 million disgorgement sanction against "Crazy Eddie" Antar in June 1990 for insider trading. Disgorgement sanctions have been imposed against violators involved in insider trading, investment adviser fraud, market manipulation, and fraudulent financial reporting.

[3]SEC v. Texas Gulf Sulphur Co., 312 F. Supp. 77 (SDNY 1970), aff'd on this point, 446 F.2d 1301 (2d Cir.), Cert. denied, 404 U.S. 1005 (1971).

The primary purpose of disgorgement is to ensure that securities law violators do not profit from their illicit activities. A secondary objective of disgorgement is to compensate investors harmed as a result of the violation. When SEC and the courts believe it is not economically practical or efficient to locate and notify potential investor claimants, disgorged funds are paid to the U.S. Treasury. While disgorgement is principally a deterrent against securities law violations, SEC and the federal courts view the disgorgement sanction as not only a deterrent but also as a means of compensating investors. A description of the process for imposing and enforcing court-ordered disgorgement is contained in appendix II.

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, through the Securities Enforcement Remedies and Penny Stock Reform Act (Remedies Act), gave SEC the authority to impose disgorgement sanctions in its administrative proceedings. SEC's Task Force on Administrative Proceedings was created in July 1990 by the former Chairman of SEC to review the rules and procedures relating to SEC's administrative proceedings. After Congress passed the Remedies Act, the task force expanded its agenda to develop recommendations to implement SEC's new powers under the act. One of the new powers is the authority to order disgorgement in administrative proceedings. The task force issued its report in February 1993, which included proposed rules for, among other things, disgorgement imposed by SEC administrative law judges. As of April 1994, the task force was reviewing comments it had received on the proposed rules before finalizing them for the Commission's approval.

SEC Does Not Maintain Aggregate Information That Could Help It Better Assess the Effectiveness of Its Disgorgement Efforts

According to SEC data, federal district courts imposed an estimated $2 billion in disgorgement sanctions in about 600 cases from 1987 through April 1994. Although SEC collects data on the imposition of disgorgement sanctions, it does not maintain aggregate information on the amount of disgorgement collected from defendants and distributed to investors or to the U.S. Treasury. Aggregate information could help SEC better assess the effectiveness of its disgorgement efforts and could point out areas where more attention is needed. For example, the aggregate amount of disgorgement collected and the proportion of that amount that was (1) distributed to investors, (2) sent to the Treasury, and (3) paid to receivers could help SEC improve the efficiency of its disgorgement efforts, better monitor the effectiveness of its collection efforts, and monitor trends in receiver costs.

Information on the distribution of funds is now available only on a case-by-case basis from the attorneys working on the cases and their files. SEC does maintain information on the amount of disgorgement collected on each case in the Office of the Secretary's Disgorgement Payment Tracking System (DPTS). DPTS tracks disgorgement ordered and collected from defendants for individual cases but does not provide aggregate information.

We obtained a printout of the individual case data from DPTS for the period from 1987 to April 1994. These data showed that about 50 percent of the $2 billion in disgorgement imposed by the courts during this period was actually collected. According to SEC enforcement attorneys, the uncollected amounts do not indicate poor collection efforts. Instead, they said the unpaid amounts usually reflect default and other judgments against defendants that, despite collection efforts, remain unpaid because defendants have either no assets or insufficient assets to satisfy the judgment.

SEC officials told us the Enforcement Division is working on an improved case tracking system so that the attorneys can easily determine the status of their cases, including the status of the disgorgement. As an interim substitute for this system, the Office of the Secretary is currently trying to obtain an off-the-shelf debt collection software system to track unpaid disgorgement. We encourage SEC's efforts to develop and obtain systems to track the status of disgorgement cases. Including aggregate information on amounts collected and distributed in the tracking system that the Enforcement Division ultimately develops would help SEC to assess the Enforcement Division's efforts more effectively.

SEC Lacks Formal Qualification Standards for Receiver Selection Process

Qualification standards and guidelines for selecting individuals to recommend as receivers are necessary to promote public confidence that the selection was made on an impartial basis. Without such standards, the selections by federal courts and SEC can convey the appearance of favoritism. However, SEC has no formal policies or qualifying standards to ensure that the receivers it recommends to the courts are selected on an impartial basis.

According to SEC attorneys, if the court wants SEC's help in selecting a receiver, SEC attorneys will contact at least three individuals and obtain proposals from them. SEC attorneys said they choose individuals to contact on the basis of their judgment and personal knowledge of the individuals.

The proposals from potential receivers are to include the individuals' credentials and the hourly rates that they will charge for their services as receivers. According to SEC attorneys, receivers often give a discount from their normal hourly rates because they consider this work a public service. SEC attorneys said they evaluate the credentials and expected charges to make a final determination on the individual to recommend for the court's consideration. The attorneys do not have formal criteria to use in their evaluation of the proposals. They said factors they look for in determining whom to recommend for receiver appointment are a good reputation, credibility, and experience in securities law or a specialized area germane to the case. Some attorneys told us that they prefer to recommend former SEC attorneys because of their relevant experience. However, the subjective judgment involved in this process and the fact that former SEC attorneys are sometimes recommended for receiver appointments in SEC disgorgement cases could give the appearance of favoritism. Qualification standards and guidelines that must be met by any potential receiver could help minimize the appearance of favoritism.

For several reasons, we could not determine exactly how many former SEC employees had been appointed as receivers or whether former SEC employees were favored in the receiver selection process. First, SEC did not have summary information on the backgrounds of receivers for all of its cases, so information on the total number of receivers who were former SEC employees was not available. Second, determining whether favoritism occurred requires detailed knowledge of the intent of the individual making the recommendation, and we found no documentation of this intent. Third, even when reviewing individual case files we could not determine whether the judges just accepted the SEC recommendations or made their own determinations as to the relative strengths of the SEC recommendations compared to other possible receiver candidates. Finally, the selection of a former SEC employee, although perhaps giving the appearance of favoritism, does not imply that the person was not the most qualified of those considered. We judgmentally selected and reviewed nine cases in which receivers were appointed. One of the receivers was appointed in two different cases, resulting in eight different individual selections. We determined that three of the eight were former SEC employees.

SEC's Task Force on Administrative Proceedings supported the need for qualification standards and guidelines for selecting receivers in administratively-imposed disgorgement cases. The Task Force report stated that the method used to select an administrator—the person

responsible for administering the distribution plan—should comply with any applicable federal law and promote public confidence that the selection was made on an impartial basis. The report proposed several alternatives, including issuing criteria required of an administrator and allowing interested parties who meet these criteria to place their names on a roster from which administrators in a particular case could be chosen. These guidelines have not been, but could be, used by SEC to recommend a receiver in court-ordered disgorgement cases because the objectives are the same regardless of whether disgorgement is ordered by a judge in federal court or by SEC in administrative proceedings.

SEC Has Weak Controls Over Receivers and the Funds in Their Possession

Monitoring receivers and the funds they hold is an important management control for ensuring that receivers adhere to their responsibility as court-appointed fiduciaries to protect the funds with which they are entrusted and to ensure they comply with court orders. SEC does not provide its attorneys with guidelines or procedures on how to monitor receivers. One way SEC attorneys can monitor receivers is by reviewing receiver fee applications. However, no requirements are placed on receivers concerning the format or contents of fee applications. Also, neither the courts nor SEC uniformly require receivers to periodically report on the status of the disgorged funds in the receivers' possession. The lack of reporting requirements, for both fee applications and accounting of funds, could result in the courts and SEC attorneys not having adequate information to monitor receivers to ensure their fees are not excessive and could provide the opportunity for fraud, waste, and abuse. Although our review was not designed to detect fraud, we found no evidence of fraud or mismanagement in the cases we reviewed. However, improved monitoring procedures could minimize the chance of fraud or mismanagement occurring in the future.

SEC Attorneys Are Not Provided Formal Guidelines for Reviewing Fee Applications

Returning disgorged funds to investors is a secondary objective of disgorgement but one of obvious importance to the harmed investors. A review of receiver fee applications is important for meeting this secondary objective because receivers' fees and expenses are paid from the disgorgement fund, decreasing the amount available for distribution to investors. The court must approve receivers' fee applications before the receivers can be compensated. SEC attorneys assist the courts by reviewing the fee applications and advising the courts of the results of their review. However, instead of formal guidelines, SEC attorneys use their own judgment to determine the reasonableness of work claimed by receivers

and their charges for that work as described in the fee applications. SEC attorneys said they generally look at (1) the hourly rate to determine if it is in compliance with the court order; (2) the amount of time spent performing services to determine whether it appears that the resulting fees are too high; and (3) expenses like postage, delivery, and travel. While these steps appear reasonable, they are not written or required of the attorneys and might not be applied consistently in all cases. For example, the courts do not always indicate a maximum hourly rate for receivers. A maximum hourly rate was contained in a court order in only five of the nine cases we reviewed. In addition, no criteria or guidance exist on what fees or expenses may be too high or questionable.

Although SEC attorneys described the factors they look at when they review receiver fee applications, we found little documented evidence that the attorneys reviewed fee applications in the nine cases we reviewed. In three cases, the files indicated that fee applications had been submitted to and approved by SEC. We found no documentation of what type of review SEC did in these three cases. In one of these three cases, the court-ordered maximum fee for the receiver was $195 per hour. The fee applications we obtained and reviewed for this case included, in addition to 188 hours of work done by the receiver, over 105 hours of work done by four other individuals of the receiver's law firm that was charged at rates varying from $360 per hour to $420 per hour. (The fee applications did not describe the work done by each individual, as discussed in the section on fee application requirements.) We could not determine from the files whether these fees were questioned before an SEC official approved the fee applications. The SEC approving official in this case told us that he discussed these fees with the receiver and was satisfied that the fees were not out of line because at least one of the individuals, a partner in the firm, is a tax expert who was consulted on tax matters that a nontax attorney would be ill-equipped to answer.

In one case, the receiver said SEC reviewed his fee application and told the court it had no objections. However, we found no documentation of this review in SEC or court files. In three other cases, we determined that applications had been submitted, but we found no evidence in the files that SEC reviewed or approved these fee applications. In the two remaining cases, the receivers said they had not yet submitted any fee applications. SEC attorneys told us it is not standard practice for litigation attorneys to document reviews of court papers or oral requests for information.

No Particular Format or Contents Are Required for Fee Applications

For SEC attorneys to have adequate information to review fee applications, receivers would need to provide a certain amount of detail about the individuals assisting them and the services they perform. However, for the cases we reviewed, no requirements were placed on receivers concerning what information should be included in their fee applications.

The court orders appointing receivers that we reviewed were prepared by SEC attorneys and approved by the courts. None contained requirements for the contents or format for receiver fee applications. We determined that receivers had submitted fee applications in seven of the nine cases we reviewed. These fee applications usually included (1) a description of the services provided by the receiver and any assistants, such as counsel, paralegal, or accountant; (2) the number of hours spent performing these services and the charges per hour and in total; and (3) reimbursable expenses paid by the receiver's firm, such as photocopying, messenger service, and telephone.

The amount of detail in the fee applications we reviewed varied. For example, a fee application submitted by the receiver in one case included a summary listing the names and positions of people performing the services, hourly rates, number of hours, and total fees requested for the period. This summary was followed by a detailed statement itemizing the services performed by each individual, their hourly rates, and the number of hours they spent on those tasks.

In contrast, the fee applications in a case involving high attorney fees (see p. 7) included only an overall description of services provided by all staff, followed by a list of the individuals, the number of hours billed per individual, the hourly rate, and total billed per person. This case differed from the first in that the fee application did not connect particular services with the individual performing the service. Also, the persons' positions were not identified. Therefore, the attorney reviewing this fee application might not have been able to determine whether particular tasks were needed or performed by the lowest cost individual, such as a paralegal, capable of performing the tasks. As discussed in the previous section, the approving official said he satisfied himself as to the reasonableness of these fees through discussions with the receiver.

Standards for contents and format of fee applications would facilitate SEC's review of receiver fee applications. An SEC senior attorney agreed that a standardized structure with appropriate detail would be useful.

Receivers Not Routinely Required to Report on Funds Status

Information on the amount of funds in receivers' possession, including earnings on such funds, where the funds were invested, fees paid to receivers, and other disbursements made from disgorged funds was also not available in every case we reviewed. This information would allow the courts and SEC attorneys to better monitor the disgorged funds held by receivers to ensure the funds are protected against fraud, waste, and abuse. Receivers in cases we reviewed were generally not required by the courts to file periodic reports with SEC or the courts accounting for disgorged funds in the receivers' possession. Rather, this type of accounting was usually required of the receivers in their final reports to the courts. Also, SEC did not recommend and the courts did not require that the disgorgement funds held by receivers be audited. Therefore, no one independent of the receivers had the information needed to monitor the funds.

Receivers in eight of the nine cases we reviewed had control of the disgorged funds. In the ninth case, the court maintained the disgorged funds in the court registry account. Court orders in six of these eight cases directed the defendants to pay the disgorgement directly to the receiver. In the other two cases, the courts ordered the defendants to pay the disgorgement to a court registry account. The courts then ordered the funds in these two cases to be transferred from the court registry accounts to the receivers when they were appointed.

Court orders appointing the receiver in three of the eight cases we reviewed in which receivers had control of the funds required the receivers to prepare and maintain complete, accurate, and legible records indicating the date, amount, and description of each asset received, each transaction, and the recipient of each disbursement made by the receiver. However, these court orders did not (1) require that receivers report such information to SEC or to the court or (2) state that the funds could be subject to audit. Court orders in the other five cases were silent regarding recordkeeping requirements.

SEC's Task Force on Administrative Proceedings reported that in administrative proceedings SEC has a responsibility to ensure that disgorged funds are safeguarded until they are distributed. This is similar to the responsibility that the courts have in court proceedings. The task force recommended that the administrators of SEC-ordered disgorgements be required to file quarterly reports accounting for money earned, received, and spent. The report stated that "Requiring periodic, public accounting is a basic safeguard for assuring that disgorged funds are

husbanded to the greatest extent possible until distributions are authorized." The task force's findings and proposed rules pertain only to disgorgement ordered in administrative proceedings. However, because SEC also assists the courts in their monitoring of court-appointed receivers, the controls the task force recommended would also be appropriate for court-ordered disgorgements. SEC would need to recommend to the courts that these controls be adopted.

Conclusions

Determining the overall effectiveness of disgorgement collection and distribution efforts is difficult for SEC managers because SEC does not track the aggregate amount of funds collected from violators and disbursed to investors, to Treasury, and to receivers for their compensation. Further, while we found no evidence of conflict of interest in the receiver selection process, the process itself is not open and public. When a former SEC employee is appointed as receiver, this could appear to be a conflict of interest.

SEC does not provide its enforcement attorneys and their supervisors written guidance for monitoring receivers' activities and requests for compensation. We recognize that flexibility is needed in monitoring receivers because SEC enforcement cases can be very different in content and are handled by different courts, judges, and SEC attorneys around the country. However, certain basic principles, such as comparing the receiver's court-ordered hourly rate to that claimed by the receiver may be applicable to many, if not all, of SEC's court cases involving receivers. Written guidance could help SEC ensure that receivers are monitored consistently, regardless of the type of case, location, or attorney involved. Such guidance could also include a standardized format for fee applications and could require receivers to report on the funds they hold. This information could help SEC determine whether requests for compensation should be questioned or whether the fund in a particular case should be audited.

The recommendations of SEC's Task Force on Administrative Proceedings covered, among other things, both appointing a fund administrator and accounting for funds earned, received, and spent by the administrator of SEC-administered disgorgement cases. These recommendations also address the weaknesses we found in SEC's management of court-ordered disgorgement cases. The recommendations could therefore also apply to these cases.

Recommendations

To help SEC better assess the effectiveness of disgorgement collection and distribution efforts, we recommend that the Chairman of SEC ensure that systems used to manage disgorgement cases include aggregate and individual case information on disgorgement ordered, disgorgement collected, amount and recipients of disgorgement distributed, and information about receivers and funds in their possession.

To help SEC preclude favoritism or minimize any appearance of favoritism in selecting individuals to recommend as receivers, we recommend that the Chairman of SEC establish formal guidelines for SEC attorneys to use for recommending individuals as receivers. In establishing such guidelines, SEC should consider issuing criteria that receivers must meet and allowing interested parties whom SEC determines meet these criteria to place their names on a roster from which a receiver could be chosen for a particular case.

And finally, to help ensure adequate oversight of receivers and the funds in their possession, we recommend that the Chairman of SEC establish a standard format for fee applications submitted by receivers. The Chairman should also establish formal written guidelines for SEC attorneys to use for monitoring receivers' activities and the funds they handle. In establishing such procedures, SEC should recommend, where appropriate, that the court orders include requirements that (1) receivers file periodic reports with SEC on the funds they hold and (2) the funds may be subject to an audit if SEC believes it necessary after reviewing the periodic reports.

Agency Comments and Our Evaluation

We provided a draft of this report to SEC for review and comment. SEC agreed with our recommendations to (1) ensure that systems used to manage disgorgement cases include aggregate and individual information, (2) establish a standard format for receivers' fee applications, and (3) require receivers who hold funds to file periodic reports on those funds.

SEC did not agree with our recommendation to establish formal guidelines for SEC attorneys to use for recommending individuals as receivers. We recommended that in establishing these guidelines, SEC consider issuing qualification criteria required of receivers and allowing interested parties to put their names on a roster. SEC said the variety of situations in which a receiver may be needed makes it difficult to generalize regarding receiver qualifications. For example, a case involving hundreds of millions of dollars and complex legal issues may require a receiver with sophisticated

knowledge of securities laws and the resources of a large law firm at his or her disposal. Another example SEC gave is that a case involving the fraudulent sale of securities in a new technology telecommunications company might require someone with an appropriate technical background.

The intent of our recommendation is to ensure that the nomination process is open to any qualified candidate and not just people known to SEC. In this regard, SEC could publicize the fact that it is establishing a receiver roster and that it is seeking candidates of various experiences and resources. The roster would indicate any special skills, knowledge, or access to resources an individual might have. It would provide SEC with a larger pool of candidates to meet any special needs and also provide the flexibility SEC needs.

SEC also commented that the court, not SEC, has control over receiver selection. We realize that in some cases a judge will select a receiver without SEC input or will not select SEC's specific recommendation. However, in other cases the judge will seek SEC's input and even ask for specific recommendations. By following our recommendation for these cases, SEC could preclude or minimize any appearance of favoritism in recommending receivers to the court.

SEC also did not agree with our recommendation to establish formal written guidelines for SEC attorneys to use for monitoring receivers. SEC said it would be impractical to prepare guidelines for its attorneys to use when reviewing receiver fee applications because of the wide variety of cases, tasks, and billing rates and practices that might be encountered. SEC said it prefers to adhere to a more flexible approach and that such guidelines would do no more than tell the attorneys to use common sense. We agree that flexibility is needed. Our intent is not to establish specific guidelines to cover every possible situation that might arise. Rather, our intent is to establish basic principles for monitoring receivers. For example, some attorneys told us they look for certain things, such as making sure the hourly rate is the rate authorized by the court, making sure the amount of time spent looks reasonable, and making sure other expenses, like postage, are not too high. These are principles that apply to most SEC court cases involving receivers. Formalizing these principles could help ensure that every attorney knows and follows them and that receivers are consistently monitored. We have expanded the conclusions section of the report to clarify our rationale for recommending that guidelines be established.

SEC's letter and our additional comments are contained in appendix III.

We are sending copies of this report to SEC and other interested parties upon request. This report was prepared under the direction of Michael A. Burnett, Assistant Director, Financial Institutions and Markets Issues. Other major contributors to this report are listed in appendix IV. Please contact either Mr. Burnett or me on (202) 512-8678 if you have any questions concerning this report.

Sincerely yours,

Helen H. Hsing

Helen H. Hsing
Associate Director, Financial
Institutions and Markets Issues

Contents

Abbreviations

SEC	Securities and Exchange Commission
DPTS	Disgorgement Payment Tracking System

Objective, Scope, and Methodology

Our objective was to determine whether SEC had procedures and management controls to (1) provide adequate information to assess the effectiveness of disgorgement collection and distribution efforts, (2) preclude favoritism or minimize any appearance of favoritism in selecting individuals to recommend as receivers, and (3) provide adequate oversight of receivers and the funds in their possession. To learn about the objectives of disgorgement, we studied the legislative history and applicable case law and interviewed Securities and Exchange Commission (SEC) officials and federal district court judges. To gain a better understanding of how the process works and to determine the roles and responsibilities of all parties involved, we interviewed SEC officials and case attorneys, federal court judges and clerks, receivers, and staff of the Administrative Office of the U.S. Courts.

To identify SEC's procedures and management controls, we requested all written procedures and controls and reports containing information on disgorgement ordered, collected, and distributed; reviewed disgorgement case files; and interviewed SEC officials and case attorneys in Washington, D.C., and New York. Because SEC had no written procedures or guidelines for its attorneys or receivers covering court-ordered disgorgement, our discussion of roles and responsibilities is based primarily on interviews with SEC officials and attorneys, federal judges and other court personnel, and receivers appointed in SEC disgorgement cases.

For the case file reviews, we judgmentally selected 15 of the 374 cases listed in the Disgorgement Payment Tracking System printout as of March 1992. Because of limited travel resources we selected cases from the home office in Washington, D.C., and the New York Regional Office. The 15 cases included 10 in which the disgorgement was paid and 5 in which the disgorgement was not fully paid. We anticipated that by selecting these cases, we would cover collections (because 5 cases still had disgorgement owed) and distributions, including any involvement of receivers and SEC oversight of the receivers (because 10 cases had disgorged funds available for distribution). SEC attorneys familiar with disgorgement cases told us that each case had unique factors, but the cases we selected would give us a general and overall view of how the process works.

Our reviews of the 15 cases initially included reviewing SEC and federal court records on these cases and interviewing SEC attorneys involved in the cases. We determined from our initial file reviews and discussions with SEC attorneys that 9 of the 15 cases involved receivers. One of the receivers

was appointed in two different cases, and two cases were heard by the same judge, resulting in eight different receivers and eight different judges. To determine (1) how the receivers were selected, (2) what their roles and responsibilities were, and (3) their involvement with and oversight by SEC, we interviewed, on the basis of their availability, six of the eight receivers and four of the eight judges involved in these nine cases. We also obtained written answers to our questions from another receiver whom we did not interview face-to-face. The results of our case reviews are not necessarily representative of all SEC disgorgement cases.

We also reviewed the report of SEC's Task Force on Administrative Proceedings to determine whether the proposed rules for handling disgorgements ordered in administrative proceedings could be applicable to court-ordered disgorgements.

We did our work between March 1992 and April 1994 at SEC in Washington, D.C., and New York and at federal district courts in New York (Southern District), New Jersey, and Washington, D.C. We met with receivers whose offices are located in Washington, D.C., New York, and New Jersey. We did our work in accordance with generally accepted government auditing standards.

SEC's Procedures for Court-Ordered Disgorgement Cases

SEC's Enforcement Division attorneys investigate alleged violations of securities laws. If the attorneys believe a violation has occurred, SEC can seek sanctions against the violator through civil litigation or administrative action; or SEC can reach a settlement with the violator. A settlement results in a judicially enforceable agreement in which the violator accepts the penalty or sanction without admitting or denying guilt. When SEC seeks a civil remedy and the violator has not agreed to a settlement, SEC attorneys can file a civil suit in federal district court against the violator. If the court agrees with SEC, it will render a judgment and can order the violator to, among other things, disgorge illegal profits.

Like all other remedies, SEC must authorize the attorneys' request for the remedy of disgorgement. SEC attorneys said they determine the amount of illegal profits they seek to be disgorged on the basis of the facts of the particular case and existing case law. SEC attorneys include this determination in a proposed court order they draft for the court's review and approval. These court orders drafted by SEC attorneys can direct that disgorgement be paid to either (1) a court registry account until the funds are disbursed; (2) SEC for transmittal to the Treasury; or (3) a court-appointed receiver, who is to invest and manage the funds until they are distributed to harmed investors. All or part of the disgorgement amount might be waived when defendants can prove that they are not able to pay. In remarks before a business law conference, an SEC Commissioner said that inability to pay can be a legitimate reason for waiving payment of disgorgement. The Commissioner said the staff has been instructed to thoroughly investigate claims of inability to pay and that defendants should provide sworn financial statements and tax returns. SEC also requires the defendants to complete a standardized statement of financial condition. The Commissioner also said that all settlements that excuse payment of disgorgement based on inability to pay will be voidable if the defendants have misrepresented their financial condition.

Once a court order for disgorgement has been issued, SEC attorneys are to pursue collection of the disgorgement amount owed from violators. Collection actions staff attorneys wish to take are to be approved by their supervisors, i.e., branch chief, assistant director, or deputy chief litigation counsel. If SEC determines that the violator is able to pay but is not making payments, it can take additional enforcement action, such as freezing the violator's assets, filing liens against or seizing the violator's property, and obtaining civil contempt judgments. SEC attorneys can also pursue disgorgement claims against defendants in U.S. bankruptcy courts. SEC has

recently hired an individual with special knowledge of bankruptcy laws to serve as the Enforcement Division's bankruptcy counsel.

SEC attorneys are to recommend to the court whether the disgorged funds, when available, should go to harmed investors or to the Treasury. According to some attorneys, the factors they might consider in making this determination include the amount disgorged, number and types of securities involved, where the securities were traded, size of each security's national daily trading volume on the days the defendants traded, and the estimated cost of administering the distribution plan. Some attorneys told us that they will decide to send the funds to the Treasury when returning disgorged funds to investors harmed as a result of the violations is not economically feasible. The attorneys said that the size of the disgorgement may be small compared with the number of harmed investors, which may be large and difficult to identify. The attorneys also may look at how previous cases were handled to help them make their decisions.

When the court agrees with SEC's determination that the funds should be disbursed to investors, SEC attorneys are to draft a distribution plan, which specifies how and to whom the disgorged funds are to be disbursed. When preparing these distribution plans, the attorneys can access the division's computerized Formfile, which contains sample distribution plans for different situations. For example, there are sample plans for (1) an insider trading case in which only one stock was traded and the district court clerk's office distributes the funds, (2) an insider trading case in which only one stock was traded and a receiver is appointed, and (3) an insider trading case in which multiple stocks were traded and a receiver is appointed. Supervisors are to review and approve distribution plans drafted by staff attorneys. SEC files distribution plans with the court for approval, and the parties involved are allowed to comment on the proposed plans.

When disgorged funds are to be distributed to investors, the court sometimes appoints a receiver to manage the funds and administer the distribution plan. Receivers are appointed to take charge of disgorged property and administer it for the benefit of harmed investors or the U.S. Treasury. In this capacity, receivers are considered court-appointed fiduciaries and are subject to the same standards of trust and confidence as other fiduciaries.

SEC has developed a procedure to solicit proposals from at least three individuals. The attorneys evaluate the proposals, which contain the individuals' credentials and expected charges for their services. Receivers generally discount their normal rates for work performed on these cases. The attorneys select one of the individuals to recommend to the court for consideration to appoint as receiver. The judge makes the final determination and has complete discretion about whether to accept SEC's recommendation or choose someone else.

The court order appointing the receiver is generally drafted by SEC attorneys and usually describes the receiver's duties and responsibilities in general terms. Depending on the case, these duties can include locating assets, investing the disgorged funds, reviewing and determining eligibility of investor claims, and distributing the funds. The court usually specifies the receiver's investment options, such as only purchasing obligations backed by the U.S. Government. The receiver is to distribute the funds pursuant to the distribution plan prepared by SEC attorneys and approved by the court. Compensation for receivers' services is paid from the disgorged funds after the court approves the receivers' fee applications. The court order appointing the receiver generally requires SEC to review the receiver's fee applications and recommend to the court whether or not to approve the fee applications.

Finally, SEC attorneys close their cases when (1) disgorged funds have been distributed, (2) disgorgement has been waived, or (3) they determine disgorgement is uncollectible. A February 1993 memorandum from the Director of the Enforcement Division to division staff instructs them to maintain information on cases in which disgorgement has been waived in the event they uncover information in the future that would invalidate the terms of the waiver. If the attorneys determine disgorgement is uncollectible, the memorandum instructs them to notify SEC that further collection efforts would be futile and give the reasons for no longer pursuing the funds. As in waived cases, if information is obtained that the defendant may be able to satisfy the disgorgement judgment, the case can be reopened for appropriate action. SEC must approve the closing of cases in which disgorgement is still outstanding.

Comments From the Securities and Exchange Commission

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

DIVISION OF ENFORCEMENT

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

June 16, 1994

Ms. Helen H. Hsing
Associate Director, Financial
Institutions and Markets Issues
United States General Accounting Office
Washington, DC 20548

Dear Ms. Hsing:

Thank you for providing us with an opportunity to review and comment on your draft report entitled "Securities Enforcement: Improvements Needed in SEC Controls Over Disgorgement Cases." The report addresses important aspects of how the courts and their receivers handle funds paid as disgorgement in SEC enforcement cases. We agree with much of what is recommended and are in fact already addressing many of the concerns it raises. Our specific comments as to several of the recommendations follow.

I. INFORMATION MAINTAINED ON DISGORGEMENT EFFORTS

The draft report recommends that, to help the SEC better assess the effectiveness of its collection and distribution efforts, it should

> ensure that systems used to manage disgorgement cases include aggregate and individual case information on disgorgement ordered, disgorgement collected, amount and recipients of disgorgement distributed, and information about receivers and funds in their possession.

As the draft observes, the SEC already maintains information on a case-by-case basis regarding the amounts of disgorgement ordered, collected, and distributed; the identity of the recipients of the funds distributed; and the receivers and funds in their possession. Such information is maintained in files kept by the attorneys working on particular cases. In addition the Secretary of the SEC maintains a computer-based Disgorgement Payment Tracking System that lists information on amounts ordered and amounts actually collected in pending cases. In our view, this information is sufficient to enable the SEC to measure the effectiveness of its disgorgement efforts.

The draft report goes on to suggest that the SEC should also maintain such information on an "aggregate" basis to enhance management's ability to assess program effectiveness. Although defining the specifications for such a system presents difficulties, the SEC has been working on one for several months and hopes

to have a workable system in place soon. To be truly useful, such a system must do far more than merely total the disgorgement ordered, collected, and distributed in all cases. To illustrate, we recently obtained a disgorgement award of $24 million that remains uncollected. That is so because the defendant, who is serving time in federal prison, has applied all his assets (with the SEC's assistance) to satisfying claims in the liquidation of the brokerage firm he once ran. If a tracking system did no more than aggregate amounts awarded and collected, one might erroneously infer in this situation that collection efforts had failed.

In seeking to devise a system that will adequately address the SEC's needs, we are exploring a number of options. For the near term, the Office of the Secretary has installed new software to better manage and access the information maintained in the Disgorgement Payment Tracking System. Looking forward, the SEC plans to continue its efforts to design and implement a system that will provide the kind of aggregate reporting that will help managers improve their ability to assess the effectiveness of the SEC's enforcement efforts. The SEC has already located one case tracking package that it believes will satisfy its needs, and last month we issued an RFI to obtain information on and evaluate other such case tracking systems.

II. QUALIFICATIONS AND SELECTION OF RECEIVERS

The draft report recommends that, although no instances of favoritism in the nomination of receivers were observed among the situations examined, the SEC should nonetheless adopt certain procedures to avoid any possible appearance of favoritism. Specifically the draft recommends that the SEC (i) publish qualifications, (ii) allow qualified individuals to place their names on a receiver "roster," and (iii) recommend only persons on the roster for possible service as receivers. These recommendations present certain difficulties in view of the range of cases the SEC handles.

Most importantly, it is the court and not the SEC that selects the receiver, and it is to the court and not the SEC to whom the receiver is responsible. Judges often do not want (or disregard) our recommendations for receivers, choosing instead to appoint a local attorney well-known to the court.

Apart from the SEC's lack of control over the selection, the variety of situations in which a receiver may be needed makes it difficult to generalize regarding qualifications. In a case involving hundreds of millions of dollars and complex legal and management issues, it may be desireable to appoint someone with sophisticated knowledge of the securities laws and the resources of a large law firm at his or her disposal. In a smaller and

simpler case, it might be wasteful to appoint such a person. In a case arising in an isolated jurisdiction and involving the distribution of assets to individuals principally in that locality, it would likely be inappropriate to pick a receiver from a roster that would likely consist principally of securities lawyers from larger metropolitan areas. In a case involving the fraudulent sale of securities in a "new technology" telecommunications company, for example, it would be necessary to appoint a receiver with the appropriate technical background. The necessary "qualifications," in other words, may vary widely from case to case.

When a court seeks recommendations, the SEC's ability to propose appropriate nominees should not be constrained by the adoption of inflexible lists of qualifications and candidates. As evidenced by the absence of any observed instances of favoritism, there are already effective checks on the process. The internal review at the SEC to which such recommendations are subjected makes it unlikely that someone will be nominated as a result of favoritism, and the court's review and exercise of judgment makes it that much less likely that someone will be appointed for that reason.[1]

See GAO comment 1.

III. CONTROLS OVER RECEIVERS AND FUNDS

GAO specifically found "no evidence of fraud or mismanagement" in court-appointed receivers' handling of disgorged funds. Nevertheless, to ensure oversight of receivers and disgorgement funds they hold, GAO recommends that the SEC ask the court in every case involving disgorgement to issue a court order that (i) requires the receiver to file periodic reports with the SEC on the funds they hold, and (ii) states that the funds may be audited if the SEC believes it necessary after reviewing the periodic reports. We agree that having receivers submit periodic reports during the course of their services could be useful in some cases, but believe that such reports should not be required in all cases. As an initial matter, in many cases disgorged funds remain on deposit in the registry of the court while we continue to litigate against

See GAO comment 2.

See GAO comment 3.

[1]The SEC is considering a roster system as one possible alternative for dealing with disgorgement under new rules governing SEC administrative proceedings. However, the reason for this more formal approach in the administrative context is that in administrative proceedings, the SEC itself is "directly responsible for appointing" the receiver, with the consequent need to "promote public confidence that the selection was made on an impartial basis." See "Fair and Efficient Administrative Proceedings: Report of the Task Force on Administrative Proceedings of the United States Securities and Exchange Commission," p. 274 (February 1993).

See GAO comment 4.

non-settling defendants. Mandatory periodic reports in these cases would raise the cost of the receivership and thereby diminish the amount of money available for distribution to defrauded investors. The amount of disgorgement involved, the location of the funds and the length of time the receiver is expected to serve should be considered in determining whether such reporting would be useful and cost effective in any given case.[2]

GAO also suggests that the SEC promulgate standards for the format and content of fee applications submitted by receivers. As in the appointment process itself, one must remember that it is the court and not the SEC that prescribes what is required of the receiver. Courts have extensive experience with fee applications from receivers and special masters in a variety of contexts. While we will consider adopting a standard form for submission to the courts describing what information should be called for in receivers' fee applications, the content of such applications ultimately is determined by the courts.

For similar reasons, we regard as impractical the suggestion that the SEC prepare guidelines to assist its attorneys in evaluating receivers' fee applications. Just as is the case with respect to other motions made to a court during litigation, fee applications must ultimately be approved by the courts, which have extensive experience in such matters. Even where the court wishes to hear from counsel for the SEC regarding fee applications, we question whether it would be feasible to promulgate meaningful guidelines that take adequately into account the wide variety of cases, tasks, and billing rates and practices that might be encountered in such settings. Here again, it is preferable, in our view, to adhere to a more flexible approach.[3]

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[2]GAO has pointed to the fact that under the proposed new rules for SEC administrative proceedings, receivers will have to submit accountings every ninety days. However, in these administrative proceedings, the SEC itself is the tribunal and, as such, "would have a responsibility to ensure that the funds are safeguarded." "Fair and Efficient Administrative Proceedings: Report of the Task Force on Administrative Proceedings of the United States Securities and Exchange Commission," p. 275 (February 1993). As noted above, in federal court litigation, it is the court that has control over the funds and directs their disposition.

[3]Essentially, such guidelines would do no more than tell the staff attorneys to use common sense -- e.g. make sure the hourly rate is the rate authorized by the court, make sure the amount of time spent looks reasonable, make sure postage and other expenses aren't too high, etc.

We appreciate the care and thought that is evident throughout your study and recommendations. If we can be of further assistance, please call me at (202) 942-4500 or the Commission's Chief Litigation Counsel, Barry Goldsmith, at 942-4622 .

Very truly yours,

William R. McLucas
Director

The following are GAO's comments on the Securities and Exchange Commission's letter dated June 16, 1994.

1. The internal review that SEC makes of receiver recommendations made by its attorneys may help ensure that conflict of interest does not occur, but it does not remove the appearance of conflict of interest.

2. The recommendation states that receivers should "where appropriate, ... file with SEC periodic reports on the funds they hold."

3. We agree that if a receiver does not have possession of or control over funds, then the recommended requirements would not be applicable. However, sometimes the funds are in the receiver's possession rather than in a court registry account. We added a paragraph to the report saying that of the nine cases with receivers we reviewed, receivers in eight of the cases were holding the disgorged funds at the time of our review.

4. As we pointed out on page 6, whether disgorgement is ordered by SEC in administrative proceedings or by a court, the objectives are the same. If SEC implements a roster system for cases decided in administrative proceedings, we see no reason why the roster could not also be used for court cases when a judge asks SEC for a recommendation.

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