

GAO

Report to the Ranking Member,
Committee on Finance, U.S. Senate

August 2007

SECURITIES AND EXCHANGE COMMISSION

Additional Actions Needed to Ensure Planned Improvements Address Limitations in Enforcement Division Operations



Highlights of [GAO-07-830](#), a report to the Ranking Member, Committee on Finance, U.S. Senate

Why GAO Did This Study

The Securities and Exchange Commission's (SEC) Division of Enforcement (Enforcement) plays a key role in meeting the agency's responsibility to enforce securities laws and regulations. While Enforcement has brought a number of high-profile cases, questions have been raised over how effectively the division manages its operations and resources. For example, GAO has previously reported on challenges Enforcement faces in managing its investigation information systems and overseeing the Fair Fund program. Under this program, funds are distributed to investors who have suffered losses resulting from securities fraud and other violations.

GAO was asked to evaluate Enforcement's (1) investigation planning and information systems, and (2) oversight of the Fair Fund program.

Among other things, GAO analyzed SEC and Enforcement documents and data and interviewed agency officials as well as consultants involved in administering the Fair Fund program.

What GAO Recommends

GAO makes several recommendations to strengthen Enforcement's management of the investigation process and the Fair Fund program. In written comments, SEC agreed with GAO's conclusions and recommendations.

www.gao.gov/cgi-bin/getrpt?GAO-07-830.

To view the full product, click on the link above. For more information, contact Orice Williams at (202) 512-8678 or williamso@gao.gov.

SECURITIES AND EXCHANGE COMMISSION

Additional Actions Needed to Ensure Planned Improvements Address Limitations in Enforcement Division Operations

What GAO Found

Enforcement's processes and systems for planning, tracking, and closing investigations had some significant limitations that hampered its ability to effectively manage operations and allocate resources. While SEC and Enforcement officials have begun addressing these issues, additional actions would ensure that limitations identified in the division's operations are fully corrected. The following summarizes key issues:

- In March 2007, Enforcement established a centralized process for reviewing and approving new investigations. Unlike the previous decentralized approach, the new process is designed to better prioritize investigation staffing and to maintain quality control in the investigative process. However, Enforcement has not yet established written procedures and assessment criteria for reviewing and approving new investigations; such procedures and criteria are needed to help effectively manage the division's operations and resources.
- By late 2007, Enforcement plans to update its current information system for managing investigations with a new system that could significantly enhance the division's operations. However, Enforcement has not taken sufficient steps to help ensure that data are entered into the new system on a timely and consistent basis to maximize the system's usefulness as a management tool.
- In May 2007, Enforcement announced plans to better ensure the prompt closure of investigations that are no longer being pursued. In the past, the division has not always promptly closed many such investigations, which may have resulted in negative consequences for individuals and companies no longer suspected of securities violations. While Enforcement's plans to address this issue are positive, they will not fully resolve the potentially large backlog of investigations that have remained open for extended periods.

Enforcement's approach to managing the Fair Fund program may have contributed to delays in distributing funds to harmed investors. While factors such as the complexity of identifying harmed investors and tax issues likely contributed to some distribution delays, Enforcement's decentralized approach to managing the program may have created inefficiencies. SEC has announced plans to centralize Fair Fund management within a new office but has not yet defined the office's roles or described its responsibilities and procedures. Therefore, it is too soon to assess how the new office will affect the Fair Fund program.

Contents

Letter		1
	Results in Brief	3
	Background	8
	Enforcement Has Taken Steps to Better Manage the Investigative Process, but These Steps May Not Fully Address Existing Limitations	14
	Enforcement’s Management of Fair Funds May Have Contributed to Distribution Delays, and the Division Lacks Data Necessary for Effective Program Oversight	23
	Enforcement Coordinates Its Investigative Activities Internally and with Other Agencies and Is in the Process of Documenting Criminal Referrals	31
	Conclusions	34
	Recommendations for Executive Action	36
	Agency Comments and Our Evaluation	37
Appendix I	Scope and Methodology	39
Appendix II	Selected Division of Enforcement Investigation and Personnel Data	42
Appendix III	Comments from the Securities and Exchange Commission	44
Appendix IV	GAO Contact and Staff Acknowledgments	48
Tables		
	Table 1: Roles and Responsibilities of SEC Divisions and Offices	8
	Table 2: The 10 Largest Fair Funds Ordered, as of June 2007	24
	Table 3: Fair Fund Orders and Distributions, as of June 2007	25
	Table 4: Ratio of Open Investigations to Staff Attorneys	42
	Table 5: Ratio of All Investigative (Staff and Supervisory) Attorneys to Paralegals	43
	Table 6: Ratio of Staff Attorneys to Supervisory Attorneys	43

Figures

Figure 1: Organizational Structure of SEC's Enforcement Division Home Office	10
Figure 2: Number of Investigative Attorneys at Fiscal Year End, 2002-2006	11
Figure 3: Flowchart of SEC's Investigation and Enforcement Process	13

Abbreviations

AIG	American International Group, Inc.
CATS	Case Activity Tracking System
ERISA	Employee Retirement Income Security Act of 1974
FINRA	Financial Industry Regulatory Authority
MUI	matter under inquiry
OCIE	Office of Compliance Inspections and Examinations
OIT	Office of Information Technology
OMB	Office of Management and Budget
OMS	Office of Market Surveillance
SEC	Securities and Exchange Commission
SRO	self-regulatory organization

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United States Government Accountability Office
Washington, DC 20548

August 15, 2007

The Honorable Charles E. Grassley
Ranking Member
Committee on Finance
United States Senate

Dear Senator Grassley:

The Securities and Exchange Commission's (SEC) ability to conduct investigations and bring enforcement actions for violations of securities laws is critical to its mission to protect investors and maintain fair and orderly markets. SEC's Division of Enforcement (Enforcement) is charged with investigating securities law violations; recommending civil enforcement actions when appropriate, either in a federal court or before an administrative law judge; and negotiating settlements on behalf of the Commission. The types of sanctions that Enforcement can seek on behalf of the Commission include monetary penalties or fines and disgorgements of the profits that individuals or companies may derive by having committed securities violations.¹ While SEC has only civil authority, it also works with various law enforcement agencies, including the United States Department of Justice (Justice), to bring criminal cases when appropriate. In addition, Enforcement is responsible for overseeing the Fair Fund program, which seeks to compensate investors who suffer losses resulting from fraud or other securities violations by individuals and companies.² Under the Fair Fund program, SEC can combine the proceeds of monetary penalties and disgorgements into a single fund and then distribute the proceeds to harmed investors.

In recent years, Enforcement has initiated high-profile actions that resulted in record civil fines against companies and senior officers and in

¹Disgorgement deprives securities law violators of ill-gotten gains linked to their wrongdoing.

²15 U.S.C. § 7246.

some cases contributed to criminal convictions.³ However, the capacity of SEC in general and Enforcement in particular to appropriately plan and effectively manage their activities and fulfill their critical law enforcement and investor protection responsibilities on an ongoing basis has been criticized in the past. Although SEC received a substantial increase in its appropriations as a result of the Sarbanes-Oxley Act of 2002, questions have been raised in Congress and elsewhere on the extent to which the agency is using these resources to better fulfill its mission.⁴ Moreover, we have reported that aspects of Enforcement's information systems and management procedures could limit the efficiency and effectiveness of its operations.⁵ For example, we found in 2004 that Enforcement faced challenges in developing the advanced information technology necessary to facilitate the investigative process.⁶ In addition, we reported in 2005 that the distribution of funds to harmed investors under the Fair Fund program was limited and that Enforcement had not developed adequate systems and data to fulfill its oversight responsibilities.⁷

Because of your interest in ensuring that SEC effectively manages its resources and helps ensure compliance with securities laws and regulations, you requested that we review key Enforcement management

³See GAO, *Mutual Fund Trading Abuses: SEC Consistently Applied Procedures in Setting Penalties, but Could Strengthen Internal Controls*, [GAO-05-385](#) (Washington, D.C.: May 16, 2005). This report generally addressed SEC enforcement actions pertaining to market timing and late trading violations. Market timing typically involves the frequent buying and selling of mutual fund shares by sophisticated investors who seek opportunities to make profits on the difference in prices between overseas and U.S. markets. Late trading is illegal and occurs when investors place orders to buy or sell mutual fund shares after the mutual fund has calculated the price of its shares but still receive that day's fund share price. As of February 2005, Enforcement had initiated 24 enforcement actions that resulted in fines of almost \$2 billion against mutual fund companies and officers for market timing and late trading violations.

⁴Pub. L. No. 107-204 § 601, 116 Stat. 745 (July 30, 2002). Amelia Gruber, "SEC Urged to Flesh Out Performance Goals," *GovernmentExecutive.Com* (Washington, D.C.: Sept. 28, 2004).

⁵GAO, *SEC Operations: Oversight of Mutual Fund Industry Presents Management Challenges*, [GAO-04-584T](#) (Washington, D.C.: Apr. 20, 2004).

⁶[GAO-04-584T](#).

⁷Section 308(a) of the Sarbanes-Oxley Act of 2002, entitled "Fair Fund for Investors," allowed SEC to combine civil monetary penalties and disgorgement amounts collected in enforcement cases to establish funds for the benefit of victims (investors) of securities law violations. 15 U.S.C. § 7246. See also GAO, *SEC and CFTC Penalties: Progress Made in Collection Efforts, but Greater SEC Management Attention Is Needed*, [GAO-05-670](#) (Washington, D.C.: August 2005).

processes and systems and follow up on our previous work where appropriate. Accordingly, this report evaluates Enforcement's (1) internal processes and information systems for planning, tracking, and closing investigations and planned changes to these processes and systems; (2) implementation of SEC's Fair Fund program responsibilities; and (3) efforts to coordinate investigative activities with other SEC divisions and federal and state law enforcement agencies.

To address all three objectives, we obtained and reviewed relevant SEC and Enforcement documentation and data. Specifically, we reviewed documentation and data relating to Enforcement's planning processes; its automated system for tracking investigations and enforcement actions—the Case Activity Tracking System (CATS)—and a planned successor system; the Fair Fund program; and internal and external coordination.⁸ We also reviewed our relevant prior reports and federal standards for internal controls. Further, we interviewed the SEC Chairman and two commissioners, senior agency and Enforcement officials in Washington, and officials in three SEC regional offices (Boston, New York, and Philadelphia) that are responsible for a significant share of Enforcement's investigative activity. We also contacted Enforcement officials in other SEC offices as appropriate. Additionally, we interviewed consultants that assist Enforcement in developing plans to distribute funds to harmed investors under the Fair Fund program.

We conducted our work in Washington, D.C., Boston, Massachusetts, New York, New York, and Philadelphia, Pennsylvania, between November 2006 and July 2007 in accordance with generally accepted auditing standards. Appendix I explains our scope and methodology in greater detail.

Results in Brief

Enforcement's processes and systems for planning, tracking, and closing investigations have had some significant limitations that have hampered the division's capacity to effectively manage its operations and allocate limited resources. While Enforcement and SEC officials are aware of these deficiencies and have recently begun addressing them, additional actions are necessary to help ensure that the planned improvements fully address

⁸CATS contains information on ongoing investigations and enforcement actions, such as the general nature of the potential violation (for example, insider trading) and the date an investigation was opened.

limitations in the division's operations. The following points summarize key issues:

- In March 2007, Enforcement said it would centrally review and approve all new investigations of potential securities law violations by individuals or companies. Under Enforcement's previous, largely decentralized approach (senior Enforcement attorneys in the agency's home and 11 regional offices could approve new investigations), the division was not always able to ensure the efficient allocation of resources or maintain quality control in the investigative process. While the new centralized approach was designed to help address these issues, Enforcement has not yet established written procedures and criteria for reviewing and approving new investigations. Without such procedures and criteria, Enforcement may face challenges in consistently communicating the new approach to existing and new staff. The lack of written procedures and criteria could also limit the Commission's ability to evaluate the implementation of the new approach and help ensure that the division is managing its operations and resources efficiently.
- Recognizing that the division's current information system for tracking investigations and enforcement actions—CATS—is severely limited as a management tool, Enforcement plans to start using a new system (the Hub) by late 2007. The deficiencies of CATS include its inability to produce detailed reports on investigations of certain types (for example, those for hedge funds) or the status of such investigations.⁹ While the Hub is designed to address many of CATS's deficiencies—it will, for example, be able to produce detailed management reports on ongoing investigations—the way that the system is being implemented may not address all existing limitations. More specifically, Enforcement has not established written controls to help ensure that staff enter investigative data in the Hub in a timely and consistent manner. Without such controls, management reports generated by the Hub may have limited usefulness, and the system's capacity to assist Enforcement in better managing ongoing investigations will not be fully realized.
- In May 2007, Enforcement implemented procedures to help ensure the prompt closure of investigations that are no longer being pursued and thereby better ensure the fair treatment of individuals and companies under review, but these procedures do not fully address the entire backlog

⁹A hedge fund is generally an entity that holds a pool of securities and other assets, is not required to register its securities offerings, and is excluded from the definition of an investment company.

of these investigations. One regional Enforcement official said that as of March 2007, nearly 300 (about 35 percent) of the office's 840 open investigations were 2 or more years old, were no longer being pursued, and had no pending enforcement actions.¹⁰ Enforcement officials said that the failure to close such investigations promptly could have negative consequences for individuals and companies no longer suspected of having committed securities violations. They attributed the failure to close many investigations to several factors, such as time-consuming administrative requirements for attorneys to prepare detailed investigation closing memorandums that then must be routed to senior division officials for review and approval. To address these issues, Enforcement plans to inform individuals and companies more promptly that they are no longer under review and expedite the review and closure of the existing backlog of investigations for which administrative tasks have been completed (as of March 2007, there were 464 such investigations). However, Enforcement's plans do not include clearing the potentially large backlog of investigations for which such administrative tasks have not been completed, which could be negatively impacting individuals and companies no longer actively under review.

Enforcement's management of the Fair Fund program may have contributed to delays in distributing funds to harmed investors, and the division lacks data necessary for effective program oversight. For the 115 Fair Funds currently tracked by Enforcement (which were created by federal courts or through SEC administrative proceedings), only about \$1.8 billion (about 21 percent) of the \$8.4 billion ordered since the program's inception in 2002 had been distributed to harmed investors as of June 2007, according to SEC data.¹¹ Enforcement officials and consultants

¹⁰Due to deficiencies in CATS, Enforcement cannot readily provide data on the number of ongoing investigations that have not resulted in enforcement actions.

¹¹These 115 Fair Funds are tracked in Enforcement's distribution management system. CATS tracks all Fair Fund distributions that have occurred but by defendant, not by fund. When a Fair Fund is created through an SEC administrative action, SEC oversees the case directly. When a fund is created through court action, SEC is a party to the court proceeding, but the court retains ultimate authority to supervise the plan. In either an administrative or court proceeding, an individual or company is ordered or agrees to pay an amount of money into a Fair Fund plan. The Fair Fund data discussed in this report do not include 24 cases that SEC had previously identified as Fair Funds. These 24 cases generally are smaller (accounting for about \$118 million or 1 percent of total Fair Funds), and their exclusion does not change the overall conclusion that distributions have been limited. Enforcement did not include some of the 24 plans because they were fully distributed to harmed investors and the division's information system only tracks Fair Fund plans that were ongoing at the time this system was established in 2006.

who administer Fair Fund plans have attributed the limited payout rate to factors such as difficulties in identifying harmed investors, the complexity of individual cases, and the need to resolve related tax issues. However, Enforcement's largely decentralized approach to managing the Fair Funds program may have also contributed to distribution delays. While senior Enforcement officials in Washington have a coordination and oversight role, staff attorneys in either the home or the regional offices that brought the related enforcement action are primarily responsible for overseeing consultants who design and execute Fair Fund distribution plans. However, this delegated management structure appears to have impeded the development of uniform Fair Fund procedures that otherwise could have facilitated the distribution of funds to harmed investors. In addition, Enforcement officials said that the management structure diverts investigative attorneys from their primary law enforcement mission. In response to these concerns, in March 2007 SEC's Chairman announced a plan to centralize the administration of the Fair Fund program within a new office. However, it is too soon to assess how this new office will affect the program because SEC has not yet staffed the office or developed written guidance to define its role, responsibilities, and procedures. Moreover, Enforcement does not yet systematically collect or analyze key Fair Fund data, such as the administrative expenses that consultants are incurring to design and execute Fair Fund plans, as we recommended in 2005.¹² While Enforcement officials agree that reviewing such data would enhance their capacity to assess the reasonableness of Fair Fund administrative costs, an information system designed to collect and report such expense data for ongoing plans is not expected to be completed until 2008. In the meantime, Enforcement has not ensured that reports intended to provide expense data for completed Fair Fund plans contain consistent information or are analyzed.¹³ Without such information, Enforcement's Fair Fund oversight capacity is limited.

Enforcement coordinates investigations and other activities with other SEC divisions and outside law enforcement authorities and is implementing our previous recommendation that it document referrals to

¹²[GAO-05-670](#).

¹³Section 201.1105(f) of title 17 of the Code of Federal Regulations, SEC's Rules of Practice regarding Fair Fund and Disgorgement Plans, generally provides, *inter alia*, that "a final accounting shall be submitted for approval of the Commission or hearing officer prior to discharge of the administrator and cancellation of the administrator's bond, if any." SEC also seeks to track activity and expenses of court-overseen Fair Funds.

criminal investigative authorities. According to Enforcement officials, they regard coordinating the division's investigative activities with SEC's Office of Compliance Inspections and Examinations (OCIE) as particularly important because OCIE staff regularly examine regulated entities and have a broad understanding of the extent of their compliance with laws and regulations. However, Enforcement officials historically have been concerned that OCIE referrals lacked sufficient information. As a result, Enforcement and OCIE have recently instituted a new committee process to formally review such referrals and track their outcome. Further, Enforcement officials said that the division has established working relationships with U.S. attorney offices and state securities regulators to leverage investigative resources. Enforcement also held coordination conferences attended by federal and state agencies. However, Enforcement is in the process of implementing our 2005 recommendation to document informal referrals of potential criminal matters, which it intends to do through the planned investigation and enforcement action tracking system—the Hub.¹⁴ Until the system is in place, Enforcement cannot readily determine and verify whether staff make appropriate and prompt referrals, and the division lacks an institutional record of the types of matters that have been referred over the years. Without such information, Enforcement's ability to manage and oversee the referral process is limited.

This report makes several recommendations designed to strengthen Enforcement's management of the investigation process and the Fair Fund program. In brief, the report recommends that the SEC Chairman direct Enforcement and other agency offices, as appropriate, to (1) establish written policies and assessment criteria for reviewing and approving new investigations, (2) establish controls to better ensure the reliability of investigative data entered into the Hub information system, (3) consider developing expedited procedures for closing investigations, and (4) establish a comprehensive plan to staff and identify the roles and responsibilities of the new Fair Fund program office and collect and analyze reports on completed Fair Fund plans.

We provided a draft of this report to SEC, and the agency provided written comments that are reprinted in appendix III. In its written comments, SEC

¹⁴GAO-05-385. In this report, "referrals" are Enforcement's interactions and consultations with law enforcement agencies on specific cases rather than the formal referral process mentioned in our 2005 report, which Enforcement no longer uses.

agreed with our conclusions and stated that it would implement all of our recommendations. Moreover, SEC officials noted that the agency has since established that the new Fair Fund office—referred to as the Office of Distributions, Collections and Financial Management—will be located within the Division of Enforcement. SEC said that a senior officer and two assistant directors will lead the operations of the office and the agency is developing the office’s responsibilities. SEC also provided technical comments, which we have incorporated as appropriate.

Background

SEC is an independent agency created in 1934 to protect investors; maintain fair, honest, and efficient securities markets; and facilitate capital formation. The agency has a five-member Commission that the President appoints, with the advice and consent of the Senate, and that a Chairman designated by the President leads. The Commission oversees SEC’s operations and provides final approval of SEC’s interpretation of federal securities laws, proposals for new or amended rules to govern securities markets, and enforcement activities. Table 1 identifies several key SEC units and summarizes their roles and responsibilities.

Table 1: Roles and Responsibilities of SEC Divisions and Offices

Division or office	Roles and responsibilities
Division of Enforcement	Conducts investigations of registered entities (such as broker-dealers and investment advisers) or unregistered entities (such as unregistered and fraudulent securities offerings over the Internet), recommends Commission action (either in a federal court or before an administrative law judge), negotiates settlements on behalf of the Commission, and works with criminal law enforcement agencies when warranted.
Division of Corporation Finance	Reviews corporate disclosures, assists companies in interpreting the Commission’s rules, and recommends new rules for adoption.
Division of Market Regulation	Establishes and maintains standards for fair, orderly, and efficient markets by regulating the major securities market participants, including broker-dealers, self-regulatory organizations (SRO), transfer agents (parties that maintain records of stock and bond owners), and securities information processors. ^a
Division of Investment Management	Regulates the investment management industry and administers the securities laws affecting investment companies and advisors.
Office of the Chief Accountant	Establishes and enforces accounting and auditing policy to enhance financial reporting and improve the professional performance of public company auditors.
Office of Compliance Inspections and Examinations	Administers a nationwide examination and inspection program for registered SROs, broker-dealers, transfer agents, clearing agencies, and investment companies and advisors to quickly and informally correct compliance problems.
Office of Economic Analysis	Serves as the chief advisor to the Commission and its staff on all economic issues associated with the SEC’s regulatory activities, analyzes the likely consequences of proposed regulations, and engages in research to support longer term SEC policy initiatives and plans.

Division or office	Roles and responsibilities
Office of General Counsel	Represents SEC in various proceedings, prepares legislative materials, and provides independent advice and assistance to the Commission, divisions, and offices.
Office of Investor Education and Assistance	Provides information to investors, seeks informal resolutions of complaints, and collects data on investor contacts to track trends in the security industry and provide intelligence to other SEC divisions and offices.

Source: SEC.

⁸SROs include national securities exchanges (stock exchanges), the Financial Industry Regulatory Authority (FINRA), and clearing agencies, which facilitate trade settlements. FINRA was created in July 2007 through the consolidation of NASD (formerly an SRO) and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange; it is now the largest nongovernmental regulator for all securities firms doing business in the United States.

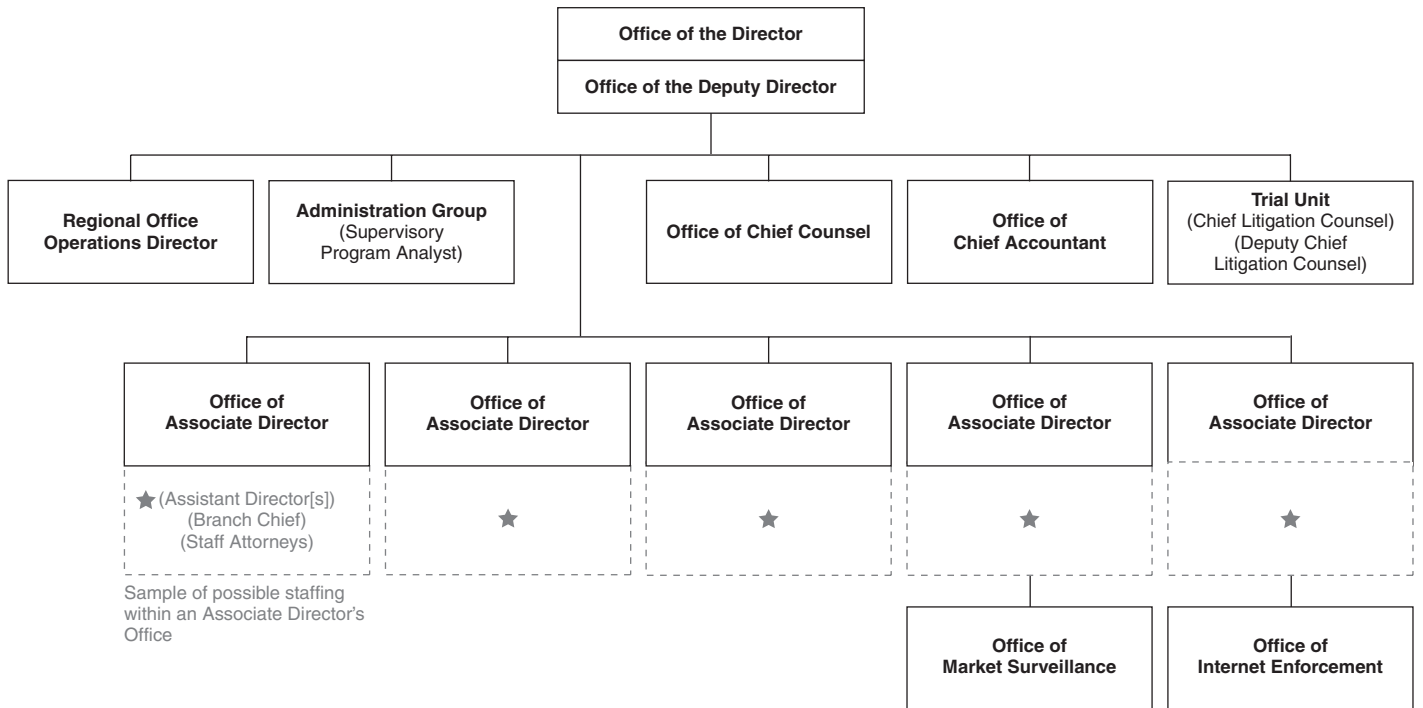
SEC's current 2004-2009 strategic plan established four goals: (1) enforce compliance with the federal securities laws, (2) promote healthy capital markets through an effective and flexible regulatory environment, (3) foster informed investment decision-making, and (4) maximize the use of SEC resources. Enforcement and OCIE share joint responsibility for implementing the agency's first strategic goal. The Commission and the Office of the Executive Director, which develops and implements all the agency's management policies, are updating the agency's strategic plan, which is to be issued in the summer of 2007.

Enforcement personnel are located in SEC's home office in Washington, D.C., as well as the agency's 11 regional offices.¹⁵ Enforcement staff located in the home office include the director and one of two deputy directors, five investigative groups or Offices of Associate Directors, as well as internal support groups, including its Offices of Chief Counsel and Chief Accountant (see fig. 1).¹⁶ An associate director heads each Office of Associate Director and has one or more assistant directors. Branch chiefs report to assistant directors and supervise the work of investigative staff attorneys assigned to individual investigations, with review and support provided by division management. SEC regional office staff are typically divided between Enforcement and OCIE personnel. Enforcement units in the regional offices have Office of Associate Director structures similar to those in the home office and report to the Director of Enforcement in Washington, D.C.

¹⁵SEC used to utilize regional offices to oversee district offices, but as of March 2007, all 11 offices were designated regional offices.

¹⁶Both deputy directors used to be located in the home office, but in April 2007, one relocated to the New York regional office.

Figure 1: Organizational Structure of SEC's Enforcement Division Home Office



Source: SEC.

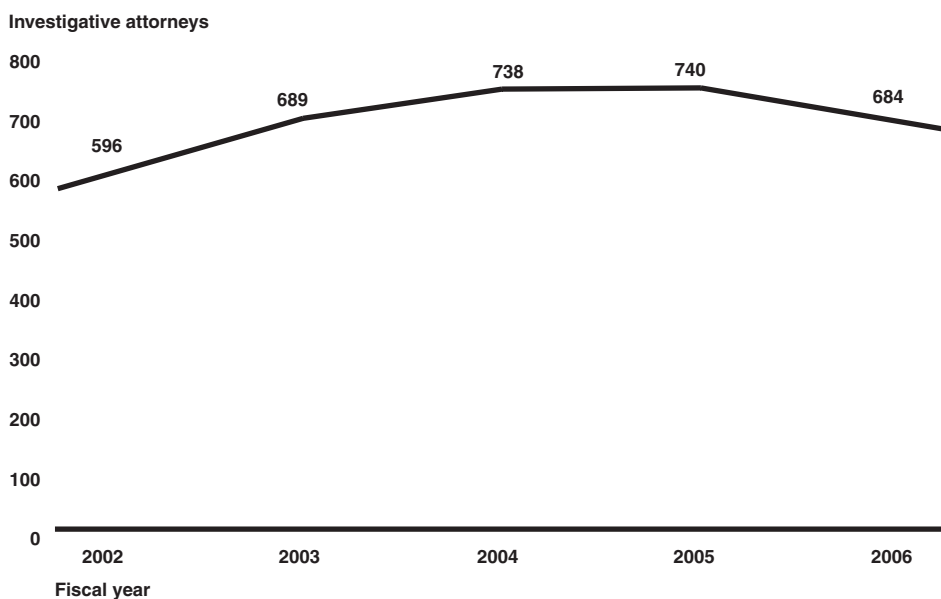
The Sarbanes-Oxley Act of 2002 substantially increased SEC's appropriations, and Enforcement subsequently increased its staffing levels. In 2002, Enforcement had 1,012 staff and, at the end of fiscal year 2006, 1,273 staff.¹⁷ As shown in figure 2, the number of investigative attorneys in Enforcement increased substantially, from 596 in 2002 to 740 in 2005.¹⁸ However, the number of staff in Enforcement, in particular its

¹⁷Regional offices comprise positions that (1) belong exclusively to Enforcement, (2) are shared by Enforcement and other teams, and (3) do not belong to Enforcement at all. For the purposes of computing the total Enforcement staff numbers, we counted only those positions that belonged exclusively to Enforcement. Pub. L. No. 107-204, tit. VI, § 601, 116 Stat. 745 (July 30, 2002); 15 U.S.C. § 78kk.

¹⁸The investigative attorney numbers include Enforcement staff with position titles of general attorney or supervisory general attorney, which do not include attorneys above an assistant director level. Examples of position titles not included in these numbers, but included in the numbers of total Enforcement staff, are case management specialist, law clerk, legal technician, paralegal specialist, research specialist, secretary, staff accountant, and trial attorney.

investigative attorneys, decreased from 2005 to 2006 because of a May 2005 hiring freeze (instituted across the agency in response to diminished budgetary resources) and subsequent attrition. Since October 2006, however, SEC has permitted Enforcement and other SEC divisions and offices to replace staff that leave the agency. However, the agency does not contemplate returning to early 2005 staffing levels. Appendix II provides additional information on Enforcement’s staffing resources and workload indicators.

Figure 2: Number of Investigative Attorneys at Fiscal Year End, 2002-2006



Source: GAO analysis of SEC data.

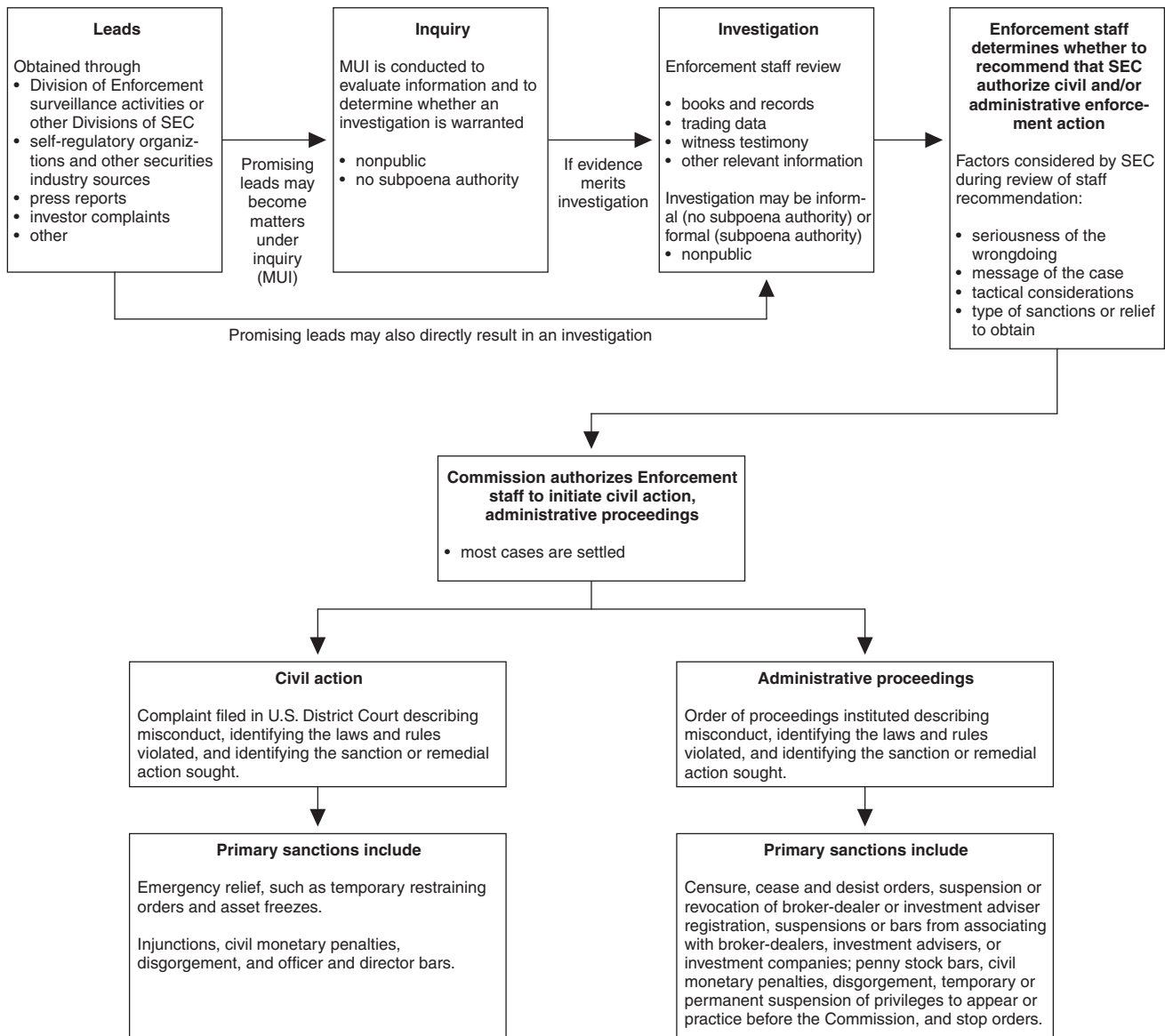
Figure 3 provides a general overview Enforcement’s investigative process. At the initial stage of the investigative process, attorneys evaluate information that may indicate the existence of past or imminent securities laws violations. The information can come from sources such as tips or complaints from the public as well as referrals from other SEC divisions or government agencies. If Enforcement staff decide to pursue the matter, they will open either a Matter Under Inquiry (MUI) or an investigation. Staff open a MUI when more information is required to determine the merits of an investigation; otherwise, staff may open an investigation immediately.¹⁹ Investigations can be conducted informally—without

¹⁹After being open for more than 60 days, an MUI automatically becomes an investigation.

Commission approval—or formally, in which case the Commission must first approve a formal order if staff find it necessary to issue subpoenas for testimony or documentation. Based on the analysis of collected evidence, Enforcement will decide whether or not to recommend that the Commission pursue enforcement actions, which can be administrative or federal civil court actions (both of which must be authorized by the Commission). Enforcement has established a variety of controls over the enforcement action process, including reviews by senior division officials in Washington, D.C., and, ultimately, review and approval by the Commission.²⁰ Enforcement has an information technology system—CATS—that tracks the progress of its MUIs, investigations, and enforcement actions.

²⁰ [GAO-05-385](#).

Figure 3: Flowchart of SEC's Investigation and Enforcement Process



Source: GAO.

Enforcement also is responsible for implementing and overseeing the Sarbanes-Oxley Act's Fair Fund provision, which allows SEC to combine civil monetary penalties and disgorgement amounts collected in enforcement cases to establish funds for investors harmed by securities laws violations.²¹ Fair Funds may be created through either SEC administrative proceedings or litigation in U.S. District Court, and either SEC or the courts may administer the funds. However, SEC is responsible for general monitoring of all Fair Funds created. Typically, for SEC-ordered Fair Funds, the agency hires consultants to create Fair Fund distribution plans (independent distribution consultants) and oversee payments to harmed investors (fund administrators). However, in some cases, SEC staff will take care of all of the distribution responsibilities internally. The development of a Fair Fund plan can include estimating losses suffered by harmed investors. For court-ordered funds, SEC recommends a receiver or distributions agent, who creates a distribution plan that is presented for court approval.

Enforcement Has Taken Steps to Better Manage the Investigative Process, but These Steps May Not Fully Address Existing Limitations

Enforcement's approaches for planning, tracking, and closing investigations have had some significant limitations that have hampered its ability to effectively manage its operations, allocate limited staff resources, and ensure the fair treatment of individuals and companies under investigation. While SEC and Enforcement officials are aware of these limitations and have begun addressing them, some of their actions may not fully correct identified weaknesses. Specifically, Enforcement has not (1) established written procedures and criteria for its newly centralized review and approval process for new investigations, which could limit its ability to ensure its consistent implementation and reduce the Commission's ability to oversee the division's operations; (2) established controls to help ensure the reliability of the investigative data that division attorneys will be required to enter into a new information system, which could limit the usefulness of management reports generated by the system; and (3) established plans and procedures to ensure that all investigations that are no longer being actively pursued are closed promptly to reduce the negative impact on individuals and companies no longer under review.

²¹15 U.S.C. § 7246.

Enforcement Recently Centralized the Review and Approval of New Investigations, but the Lack of Written Procedures and Criteria Could Limit the Effectiveness of its Approach

To establish overall investigative priorities, Enforcement officials said that they regularly communicate with senior SEC officials and their counterparts in other agency units. For example, Enforcement officials said that they hold weekly meetings with the SEC Chairman and other commissioners as appropriate. During the Chairman's tenure, he has identified the pursuit of securities fraud against senior citizens as a key investigative priority for Enforcement and other agency offices, including OCIE.²² In addition to specific priorities, Enforcement officials said that they seek to maintain a constant investigative presence across all areas of potential securities violations (for example, insider trading abuses) and that this "cover the waterfront" approach is designed to prosecute and possibly deter securities law offenders. While an Enforcement official said that the division has not established minimum quotas for different types of investigations and enforcement actions, it will intervene if any one type threatens to overwhelm the division's operations. Based on internal analysis of enforcement action data, Enforcement officials determined that if the division's pursuit of any type of securities enforcement action exceeded 40 percent of total enforcement actions, an unacceptable commitment of division resources would result.²³

While Enforcement has established planning processes for determining overall priorities, the division has used a largely decentralized approach for reviewing and approving individual new investigations, which may have limited the division's operational effectiveness, according to senior SEC and Enforcement officials. Under this traditional approach, associate directors in either SEC's home or 11 regional offices approved the opening of MUIs after staff came across a potential violation of federal securities law.²⁴ While Enforcement's senior leadership in the home office reviewed proposals for formal investigations and received weekly reports on MUIs

²²The Chairman stated that millions of individuals are expected to retire in the coming decade, meaning they will need to actively manage their investment accounts, and many individuals and companies may seek to take advantage of this increased investment activity and defraud them of their savings. Testimony of SEC Chairman Cox before the U.S. House Subcommittee on Financial Services and General Government, Committee on Appropriations, 110th Congress, 1st session, March 27, 2007.

²³An Enforcement official told us that the 40 percent limit was established based on analysis of 20 years of enforcement action data.

²⁴This process does not apply to MUIs that are opened based on referrals from SROs. Referrals from SROs are sent directly to Enforcement's Office of Market Surveillance in the home office, which then reviews the referral, decides whether or not to open a MUI, and, if one is opened, sends the MUI to the appropriate office for action.

and new investigations that had been approved in each office (and reviewed summaries of all investigations on a quarterly basis), it did not have formal approval responsibility for such new MUIs and investigations. According to Enforcement officials, staff in each office generally decided to open MUIs and investigations based on considerations such as the likelihood that they would be able to find and prove a violation of federal securities laws, the potential amount of investor loss, the gravity of the misconduct, and the potential message the case would deliver to the industry and public. Typically, the staff attorney who opened the MUI was responsible for conducting the investigation. According to Enforcement officials, this decentralized approach was generally viewed as fostering creativity in the investigative process and providing staff with incentives to actively seek potential investigations.

However, without a centralized control mechanism for reviewing and approving all new MUIs and investigations, Enforcement's capacity to ensure the efficient use of available resources, which is one of SEC's four strategic goals, was limited. For example, SEC's Chairman, officials from his office and the Office of the Executive Director, and Enforcement officials said that the division has not always been able to prioritize or ensure an efficient allocation of limited investigative staff resources. Officials said that in some cases staff attorneys worked on investigations that were outside of their geographic area (for example, San Francisco staff conducting an investigation in the Atlanta region). Consequently, the officials said that the division incurred travel and other related costs that could have been minimized if a centralized process had been in place to approve all new investigations. Further, one official from the Chairman's office said that without a formal quality check by senior Enforcement officials, in some cases MUIs and investigations had been opened and allowed to linger for years with little likelihood of resulting in enforcement actions.

In March 2007, Enforcement began using a new, more centralized approach to review and approve investigations. Under the new approach, two deputy directors, who report directly to the Director of Enforcement, are to review and approve all newly opened MUIs and investigations to ensure the appropriateness of resource allocation considerations and whether the MUI should be pursued. One deputy director is to review MUIs opened in the division's home office and another deputy director, based in New York, is to review MUIs opened in regional offices. In addition to the MUI review, after an investigation is open for 6 months, staff will be required to prepare a memorandum with information on evidence gathered to date, whether an enforcement action is likely,

resources, and estimated time frames for review by their deputy director. According to Enforcement officials, the goal of this new approach is to provide early assessments of whether an investigation ought to be pursued further and resources reallocated. The deputy directors are also expected to use this review to determine if the investigation is being conducted in a timely manner, if it should be reprioritized based on Enforcement's current caseload, or if it should be closed.

While these are positive developments, Enforcement has not yet established comprehensive written policies specifying how the new approach will be carried out or the criteria that will be used to assess new MUIs and ongoing investigations. According to our and Office of Management and Budget (OMB) standards, documentation is one type of control activity that will help ensure that management's directives, such as these new procedures, are carried out.²⁵ In spring 2007, Enforcement developed and distributed divisionwide a one-page planning document that, among other items, identified the new centralized approach for reviewing and approving MUIs and investigations. However, without the establishment of agreed-upon and written procedures for carrying out the new approach and relevant assessment criteria, the division may face challenges in consistently communicating and explaining the new approach to all current and new staff. Moreover, the Commission's ability to oversee how effectively Enforcement is implementing the new approach and generally managing its operations may be limited. For example, the lack of a transparent and documented standard could limit the Commission's capacity to identify inconsistencies in the implementation of the new approach, determine whether any such inconsistencies have affected Enforcement's operations, and take corrective action as warranted.

²⁵See GAO, *Standards for Internal Control in the Federal Government*, [GAO/AIMD-00.21.3.1](#) (Washington, D.C.: November 1999) and Office of Management and Budget, *Management's Responsibility for Internal Control*, OMB Circular No. A-123 Revised, Appendix A, "Internal Control Over Financial Reporting" (Washington, D.C.: December 2004).

Planned Investigative Information System Has Significant Potential Benefits, but Enforcement Has Not Taken Sufficient Steps to Help Ensure Data Reliability

Enforcement officials have consistently stated that the division's current information system for tracking investigations and enforcement actions—CATS—is severely limited and virtually unusable as a management tool. In particular, the officials have said that access to CATS is limited and the system does not allow division management to generate summary reports, which could be used to help manage operations on an ongoing basis. Currently, the only summary reports CATS readily produces for management review are lists of all open MUIs, investigations, and enforcement actions by general violation types, such as violations involving broker-dealers or investment advisers. CATS does not allow its users to create timely reports on more specific topics, such as ongoing investigations involving hedge funds, which do not exist as classification fields in the system. As a result of the system's limitations, several senior Enforcement management officials said that they maintain their own manual lists of certain types of investigations (such as those for hedge funds) to assist in managing division activities.

Further, to obtain customized reports and statistics on Enforcement operations, division officials said that they must submit requests to SEC's Office of Information Technology (OIT) and then wait for OIT staff to create and run a computer program to respond to the request. Enforcement officials said that OIT staff generally are responsive and work very hard to address these requests; however, given their heavy workload, one Enforcement official said that it generally takes 1-2 days to receive the information, and more complex requests can take as long as a week. Further, Enforcement officials said that obtaining technical support for CATS can be difficult because the system is proprietary and the company that created it is no longer in business. According to Enforcement officials, CATS's deficiencies result from the fact that the system was hastily designed in preparation for expected year 2000 technical challenges.

Having recognized CATS's limitations, SEC and Enforcement officials are developing a new investigation information management system, called the Hub, which is scheduled to be in use divisionwide by the end of fiscal year 2007. According to Enforcement officials, division officials and staff in SEC's Boston office developed a prototype of the Hub in 2004 because of their dissatisfaction with CATS. Subsequently, Enforcement, in coordination with OIT, developed an enhanced version of the Hub, which was then tested among home and regional office staff in late 2006 and early 2007. Enforcement officials said that the Hub is an interim system that will continue to interface with the CATS database until the second

phase of the Hub fully replaces CATS, which is expected to occur in fiscal year 2009.

Although the Hub is an interim system, Enforcement officials said that it will significantly enhance the division's capacity to manage the investigative process. In particular, the officials said that the Hub will facilitate the creation of a variety of management reports on the division's investigative activities, including detailed reports on ongoing investigations by certain types (for example, reports on the number of hedge fund investigations). The Hub will also provide more detailed information on the status of investigations so management can better track their progress and timeliness. Further, the officials said that the Hub is designed to be (1) generally accessible to all division staff, although highly sensitive investigative information will be restricted on a need-to-know basis; (2) user-friendly, primarily employing drop-down menus for data entry; (3) searchable so that staff can identify relevant information associated with an investigative matter; and (4) flexible, because new data fields can be added. We reviewed prototype screens for the Hub and found that they were consistent with the descriptions of Enforcement officials, and staff we contacted generally made favorable comments about the system.

However, due to significant planned changes to Enforcement's traditional approach for recording investigative data, there is a risk that data may not be entered into the Hub on a timely and consistent basis, as required by federal internal control standards.²⁶ Enforcement has traditionally required support personnel or case management specialists (rather than attorneys) to enter investigative data into CATS because of the limited access to the system and its lack of user friendliness. However, once the Hub is implemented in late 2007, Enforcement officials said that they plan to require division attorneys to enter relevant data into the system for all investigations opened after that date. Further, Enforcement officials said that attorneys will be responsible for entering relevant data into the Hub for ongoing investigations that are being actively pursued but were initiated prior to the system's implementation.²⁷ Enforcement officials

²⁶[GAO/AIMD-00.21.3.1](#).

²⁷Enforcement officials said that ongoing investigation data maintained in CATS will be electronically transferred to the Hub when the system is implemented. However, division attorneys will be responsible for entering relevant data into the Hub for ongoing investigations that are not maintained in CATS, such as detailed information on the type of investigation (e.g., whether it is a hedge fund investigation).

regard the entry of such data as critical; otherwise, management reports generated by the Hub would only include information on investigations begun after the system's scheduled implementation in late 2007. One Enforcement official said that the decision to require attorneys to enter data into the Hub was based on the view that such attorneys have first-hand knowledge of ongoing investigations and thus would be able to streamline the process. However, another Enforcement official said that requiring attorneys to maintain timely, accurate, and consistent investigative data in the Hub would require a cultural change on the attorneys' part because they have become accustomed to relying on case management specialists to perform this task. Another Enforcement official questioned whether division attorneys would enter investigative data into the Hub on a timely and consistent basis because they may view doing so as another administrative requirement diverting them from their primary investigative responsibilities.

While Enforcement's plans to require attorneys rather than case management specialists to enter data into the Hub may be appropriate, the division plans only a limited number of actions to ensure that data entered into the system are timely, consistent, and reliable. For example, Enforcement plans to train attorneys on the Hub as it is implemented and is developing a system user manual. However, Enforcement is not developing written guidance identifying data entry into the Hub as a priority for division attorneys and specifying how and when such data entry is to be done. Moreover, Enforcement has not yet established a written process that would allow division officials to independently review and determine the extent to which data entry for the Hub is performed on a timely, consistent, and reliable basis in accordance with federal internal control standards.²⁸ Without doing so, the usefulness of management reports generated by the Hub may be limited, and the system's potential to significantly enhance Enforcement's capacity to better manage the investigative process may not be fully realized.

²⁸In addition to directing federal agencies to establish written controls, [GAO/AIMD-00.21.3.1](#) and OMB Circular A-123 call for the establishment of controls to ensure the reliability of data maintained in information systems.

Enforcement Has Planned Improvements to Its Investigation Closure Processes, but Plans May Not Fully Address Backlog of Cases

Enforcement may leave open for years many investigations that are not being actively pursued with potentially negative consequences for individuals and companies no longer under review. According to CATS data, about two-thirds of Enforcement's nearly 3,700 open investigations as of the end of 2006 were started 2 or more years before, one-third of investigations at least 5 years before, and 13 percent at least 10 years before. According to an Enforcement official, technical limitations in CATS make it difficult to readily determine how many of these investigations resulted in enforcement actions and how many did not.²⁹ Nevertheless, other data suggest that the number of aged investigations that did not result in an enforcement action may be substantial. For example, Enforcement officials at one SEC regional office said that as of March 2007, nearly 300 of 841 open investigations (about 35 percent) were more than 2 years old, had not resulted in an enforcement action, and were no longer being actively pursued.

Enforcement officials cited several reasons for division attorneys not always closing investigations promptly. In particular, the officials said that Enforcement attorneys may view pursuing potential securities violations as the division's highest priority and lack sufficient time, administrative support, and incentives to comply with established administrative procedures for closing investigations. For example, Enforcement requires attorneys to complete closing memoranda for each investigation that is to be closed. These memoranda must identify why the investigation was opened, describe the work performed, and detail the reasons for recommending that the investigation be closed without an action. Staff must also prepare draft termination letters, which inform individuals or companies that they are no longer under review. A closing memorandum is also required for investigations with associated enforcement actions. In these cases, the staff attorney must account for all ordered relief before the investigation is closed. One regional Enforcement official estimated that it could take as long as a month for a staff attorney to complete this process and submit the closing package to the home office, although senior division officials noted that attorneys typically would not spend all their time doing so. Once closing packages are received by the home

²⁹We requested that SEC provide data on the number of investigations open for 2 or more years that have outstanding enforcement actions. To respond to this request, an Enforcement official said that OIT would have had to spend a great deal of time creating complex programs. Due to other demands on OIT's resources and our ability to obtain related data from an SEC regional office, we decided not to request that OIT provide this information.

office, Enforcement's Office of Chief Counsel must then approve the closing of the investigation, at which point final termination letters are sent to affected individuals and companies.

Enforcement officials in SEC's home office said that a lack of resources in their office also contributed to delays in closing investigations. They noted that only one person in the division was assigned to processing closing packages for investigations. Consequently, the officials said there was a backlog of investigations for which the closing package had been completed but not reviewed. As of March 1, 2007, the backlog consisted of 464 investigations, according to an Enforcement official.

However, Enforcement officials told us that in May 2007 they began eliminating the backlog of investigations with completed—but unreviewed—closing packages and had almost eliminated the backlog by mid-June 2007. The division recently added one staff person to work on administering closing procedures in the home office, and Enforcement officials have set a goal of processing new closing documentation within 2 weeks of receipt.

Also in May 2007, Enforcement implemented revised procedures for sending termination letters for investigations that will not result in an enforcement action. Under the procedures, Enforcement will send the letters to individuals and companies at the start of the closing process rather than at the end. This particular effort will be emphasized on Enforcement's intranet—EnforceNet. Enforcement officials said they changed this procedure out of concerns about fairness to those under investigation and to reduce any negative impact an open investigation may have on them. For example, a company may bar an individual from performing certain duties until a pending SEC investigation is resolved. Staff are generally encouraged to close investigations if they know they will not be bringing any enforcement actions, even if all of their investigative steps have not yet been completed.

While the above steps are a positive development, they do not address the potentially large backlog of investigations that are not likely to result in enforcement actions and for which closing packages have not been completed. As a result, the subjects of many aged and inactive investigations may continue to suffer adverse consequences until closing actions are completed. We recognize that reviewing and resolving this potentially large backlog of investigations and enforcement actions likely would impose resource challenges for Enforcement. Nevertheless, the failure to address this issue—potentially through expedited administrative

closing procedures for particularly aged investigations—would limit Enforcement’s capacity to manage its operations and ensure the fair treatment of individuals and companies under its review.

Enforcement’s Management of Fair Funds May Have Contributed to Distribution Delays, and the Division Lacks Data Necessary for Effective Program Oversight

According to available SEC data, the distribution of funds to harmed investors under the Fair Fund program remains limited after 5 years of operation. Enforcement officials, as well as consultants involved in Fair Fund plans, have cited a variety of reasons for the slow distribution, including challenges in identifying harmed investors, the complexity of certain Fair Funds, and the need to resolve tax and other issues. However, the largely decentralized approach that Enforcement and SEC have used in managing the Fair Fund program may also have contributed to distribution delays. SEC has announced plans to create a central Fair Funds office, but it is too early to assess this proposal, as final determinations about its staffing, roles and responsibilities, and procedures have not yet been determined. Further, Enforcement does not yet collect key data necessary to effectively monitor the Fair Fund program (such as data on fund administrative expenses for ongoing plans) because an information system designed to capture such data is not expected to be implemented until 2008. In the meantime, Enforcement has not ensured that reports intended to provide expense data for completed Fair Fund plans contain consistent information or are analyzed. Until Enforcement clearly defines the Fair Fund office’s oversight roles and responsibilities and officials establish procedures to consistently collect and analyze additional data, the division will not be in an optimal position to help ensure the effective management of the Fair Fund program.

Fair Fund Distributions Have Been Limited

As of June 2007, Enforcement officials said that they were tracking 115 Fair Funds created since the program’s inception in 2002—up from the 75 identified in our 2005 report—largely because funds were created as part of a series of enforcement actions against mutual fund companies.³⁰ The Fair Fund plans vary considerably in size and complexity, ranging from

³⁰GAO-05-670. The Fair Fund data do not include 24 cases that SEC had previously identified as Fair Funds. These 24 cases generally are smaller (accounting for about \$118 million or 1 percent of total Fair Funds), and their exclusion does not change the overall conclusion that distributions have been limited. Enforcement did not include some of the 24 plans because they were fully distributed to harmed investors and the division’s information system tracks only Fair Fund plans that were ongoing at the time this system was established in 2006.

plans for small broker-dealers with relatively few customers to large corporate cases, according to SEC data. The smallest Fair Fund plan established (measured by the amount of funds ordered returned to investors) was \$29,300 for alleged fraud at a hedge fund; the largest was \$800 million for alleged securities fraud at American International Group, Inc. (AIG). Table 2 shows the 10 largest Fair Funds ordered through June 2007; 7 are court-created plans, and 3 have been established through SEC administrative proceedings. SEC monitors all Fair Fund plans regardless of their source.

Table 2: The 10 Largest Fair Funds Ordered, as of June 2007

Fair Fund	Alleged type of activity	Source	Judgment date	Total ordered
AIG	Improper accounting and workers' compensation practices	Court	2/17/2006	\$800,000,000
Worldcom	Overstating income	Court	7/7/2003	\$750,000,000
Wall Street research analysts	Research and investment banking conflicts of interest	Court	10/31/2003	\$432,750,000
Enron	Earnings manipulation	Court	7/30/2003	\$422,995,012
Invesco/AIM	Market timing trading in mutual funds	SEC	10/8/2004	\$375,840,004
Bank of America	Market timing trading and late trading in mutual funds	SEC	2/9/2005	\$375,000,000
Fannie Mae	Fraudulent accounting	Court	8/9/2006	\$350,000,000
Time Warner	Overstating online revenue and number of Internet subscribers	Court	3/29/2005	\$300,000,000
Qwest	Overstating income	Court	6/22/2004	\$253,606,432
Alliance	Market timing trading in mutual funds	SEC	4/28/2005	\$250,850,003

Source: SEC.

According to SEC data, from 2002 to 2007, federal courts and SEC administrative proceedings ordered individuals and entities subject to SEC enforcement actions to pay a total of \$8.4 billion into Fair Fund plans, an increase of about 75 percent from the \$4.8 billion total Fair Funds we identified in our 2005 report. As of June 2007, \$1.8 billion of the \$8.4 billion (about 21 percent) had been distributed to harmed investors, according to SEC data. As shown in table 3, the amount distributed from court-overseen

plans exceeded that distributed from SEC-overseen plans. According to Enforcement officials, the funds were distributed more slowly from SEC-overseen plans largely because much of the money ordered through SEC proceedings involves mutual fund market timing matters, which, as discussed later, are among the most complex Fair Fund plans.

Table 3: Fair Fund Orders and Distributions, as of June 2007

	SEC-overseen Fair Funds	Court-overseen Fair Funds	All Fair Funds
Number of plans	46	69	115
Total amount ordered (in thousands)	\$3,934,371	\$4,512,860	\$8,447,231
Total amount distributed (in thousands)	\$644,450	\$1,122,351	\$1,766,802
Percent distributed	16.4	24.9	20.9

Source: GAO analysis of SEC data.

Fair Fund Distribution Delays Have Been Attributed to Difficulties in Identification of Harmed Investors, the Complexity of Certain Cases, and Tax Issues

According to Enforcement officials and consultants who work on Fair Funds, a key reason for the slow distribution of Fair Funds has been the difficulty of identifying harmed investors in certain cases. Unlike typical securities class action lawsuits, Fair Funds may not rely on a claims-based process in which injured parties identify themselves by filing claims with trustees or other administrators. For example, in Fair Fund cases involving mutual fund market timing abuses, which account for many funds ordered into Fair Fund plans, Enforcement attorneys and plan administrators have assumed responsibility for identifying harmed investors. This step was taken because with the large number of affected investors and the nature of market timing violations, many such investors may not even have been aware that their accounts experienced losses.³¹ One Fair Fund plan consultant said that many harmed investors already had redeemed their shares in the affected mutual fund companies in prior years. Tracking down such former customers can be challenging because they may have changed their addresses several times, the consultant said. Several consultants and Enforcement officials also said that tracking down customers can be hard because securities brokers, through whom individuals may purchase mutual funds, may maintain customer account

³¹Market timing losses generally were distributed across many individual mutual fund customers. The losses were often small and investors may not even have realized that their account balances were experiencing dilution for extended periods. They also may have redeemed their shares in the mutual fund company while market timing violations were occurring.

information rather than the mutual fund company itself.³² As a result, a Fair Fund administrator might need to contact and obtain the cooperation of relevant broker-dealers to obtain customer account information and make related distributions.

The complexity of some cases can also impede the timely distribution of Fair Funds. For example, in mutual fund market timing cases, sophisticated analysis might be required to first identify trades that benefited from improper activity and then to calculate profits earned from those transactions and associated losses to investors, which may be spread across many such customers.³³ According to a Fair Fund plan consultant and Enforcement officials, another significant challenge to the Fair Fund distribution involves retirement plans and the Employee Retirement Income Security Act of 1974 (ERISA), the federal law setting minimum standards for pension plans in private industry.³⁴ Retirement plans hold assets on behalf of their beneficiaries, and it is not unusual for those assets to be invested with entities that become subject to Fair Fund enforcement actions. Thus, ERISA-covered retirement plans will be entitled to Fair Fund proceeds by virtue of such investments. But depending on circumstances, a Fair Fund distribution consultant may need to make determinations on a variety of complex issues before funds can be distributed, such as determining when such distributions become plan assets under ERISA.³⁵ One Fair Fund consultant told us he spent a

³²Broker-dealers may maintain such customer account information on an aggregated basis in what are known as omnibus accounts, and the mutual fund would not have direct access to this information.

³³Market timing is said to dilute the value of mutual fund shares, as a market timer buys, sells, or exchanges shares rapidly and repeatedly to take advantage of favorable prices. In addition, market timing increases transaction costs for mutual funds. To take account of investor losses due to dilution, a Fair Fund distribution plan might attempt to estimate, on a daily basis, the extent to which a fund's net asset value (analogous to share price) would have been more or less than the actual net asset value had market timing not occurred. The difference, where positive, is the estimate of dilution and harm to investors. The sum of daily increments (both positive and negative) represents aggregate harm to a fund's shareholders over the period in which market timing occurred.

³⁴Pub. L. No. 93-406, 88 Stat. 829 (Sept. 2, 1974).

³⁵In some cases, retirement plans will be shareholders of record and receive Fair Fund distributions directly. In other cases, an intermediary—such as a broker-dealer, underwriter, or record-keeper—will be the shareholder of record, and retirement plans will receive Fair Fund distributions based on their interest in an account operated by the intermediary.

year waiting for Department of Labor clarification of relevant ERISA issues.

Finally, determining the tax treatment of funds may also slow the distribution process. According to Fair Fund consultants, tax information must accompany Fair Fund distributions to investors so that recipients have some idea of how to treat their payments for tax purposes. Consultants and Enforcement officials told us that determining appropriate tax treatment has been time-consuming as they had no precedents upon which to draw. Depending on circumstances, an investor's recovery of disgorged profits can constitute ordinary income or a capital gain—which can be taxed at different rates—or not represent taxable income at all. SEC ultimately hired a consulting firm to handle tax issues. One Fair Fund consultant told us that obtaining tax guidance from the Internal Revenue Service delayed the plan's distribution by about 1 year.

Enforcement's Approach to Managing Fair Funds May Also Have Slowed Distributions, and SEC Has Not Defined Responsibilities of a New Office to Administer the Program

In addition to the factors discussed above, Enforcement's largely decentralized approach to managing the process may also have contributed to delays in the distribution of Fair Funds. Currently, Enforcement staff attorneys in either SEC's home office or 1 of its 11 regional offices who are pursuing individual enforcement cases take a lead role in the Fair Funds process, overseeing much of the work necessary to establish and maintain a fund. This includes supervising cases directly, overseeing consultants who design or administer distribution plans, and advising or petitioning courts presiding over Fair Fund plans. Enforcement officials said that the approach made sense from a Fair Fund administration standpoint because division attorneys have substantial knowledge of the regulated entity involved and the relevant enforcement action. Enforcement officials also said that senior officials in the home office have always played an important role in the oversight of the program. Their responsibilities have included providing guidance on selecting consultants, leading information-sharing and problem-solving efforts (for example, leading regular conference calls among fund consultants, parties involved in Fair Fund enforcement actions, their legal counsel, and SEC staff in Enforcement and elsewhere), and reviewing proposed Fair Fund distribution plans and recommending modifications as necessary.

Outside consultants hired to design and implement Fair Fund plans told us that Enforcement staff attorneys assigned to their cases were dedicated and responsive and that the agency appears to be making a good faith

effort to implement and oversee the Fair Funds provision. However, they also said that Enforcement's delegated approach has resulted in delays, higher costs, and unnecessary repetition of effort. With different Enforcement staff handling different Fair Fund cases, the consultants said that Enforcement forgoes the opportunity to build institutional expertise and efficiencies. For example, one consultant said that Enforcement's delegated management of the Fair Fund program has resulted in inefficiencies in key administrative aspects of the program, such as the development of standardized means of communicating with investors (for example, form letters) and the mechanics for distributing funds to them. Consequently, the consultant said that the Fair Fund program incurs a substantial amount of unnecessary administrative costs. Further, the consultants generally agreed that it would make sense for SEC to consider centralizing at least some aspects of the administration of Fair Fund plans to improve the efficiency of the distribution process.

While Enforcement officials have cited benefits associated with the current management of the program, both SEC and division officials also acknowledged that it has created challenges. An official within the Chairman's office said that the slow distribution of funds to harmed investors is of significant concern to the agency and that the lack of a centralized management approach has limited the development of standardized policies and controls necessary to facilitate disbursements. Further, Enforcement officials said that while Fair Fund work is important, it can divert investigative attorneys from pursuing other cases. The officials said that the Fair Fund workload on any particular case varies over time, but during peak periods it can consume about 50 to 75 percent of a staff attorney's time. At one SEC regional office, Enforcement officials said that administering the Fair Fund program has resulted in a significant commitment of attorneys' time, especially because the office lost almost 25 percent of its investigative staff due to attrition in the past year or so.

In response to concerns about the slow distribution of Fair Fund proceeds to harmed investors, SEC's Chairman took two actions in 2007. First, he established an internal agency committee to examine the program's operation. The committee—which includes representatives from Enforcement, General Counsel, the Office of the Secretary, and the Office of the Executive Director—is assessing lessons learned in program implementation, the agency's selection of consultants to administer the plans, and SEC's policies and procedures for managing the program. An Enforcement official said that the committee is expected to complete its analysis by September 30, 2007. Second, in March 2007, the Chairman

announced plans to create a centralized Fair Fund office.³⁶ The Chairman stated that the purpose of the new office is to develop consistent fund distribution policies and dedicate full-time trained staff to ensure the prompt return of funds to harmed investors.

While creating a central office within SEC could facilitate the distribution of Fair Funds, it was not yet possible to assess the planned office's potential impact at the time of our review. For example, SEC had not announced which SEC unit the office would report to, although one official said that the office probably would be located within Enforcement. Further, SEC had not staffed the new Fair Fund office and had not established the roles and responsibilities of the new office or written relevant policies and procedures.³⁷ For example, SEC had not determined the extent to which the new office might assume complete responsibility for managing at least some Fair Fund plans, although it is expected the office will continue to provide support to division attorneys who currently manage such plans. Until such issues are resolved, the new office's potential efficiency in more quickly distributing Fair Fund proceeds to harmed investors will not be realized.

Enforcement Does Not Yet Collect Key Data Necessary to Effectively Oversee the Fair Funds Program

Enforcement does not collect key data, as we recommended in 2005, to aid in division oversight of the Fair Fund program.³⁸ In particular, Enforcement does not systematically collect data on administrative expenses for all ongoing Fair Fund plans. These costs range from fees and expenses that Fair Fund administrators and consultants charged to the costs of identifying harmed investors and sending checks to them. Approximately two-thirds of individual Fair Funds pay for administrative costs from fund proceeds, so that the greater the administrative expenses, the less money is available for distribution to harmed investors, according to our analysis of SEC Fair Fund information.³⁹ However, without data on

³⁶See testimony of SEC Chairman Cox before the U.S. House Subcommittee on Financial Services and General Government, Committee on Appropriations, 110th Congress, 1st session, March 27, 2007.

³⁷[GAO/AIMD-00.21.3.1](#) and OMB Circular A-123.

³⁸[GAO-05-670](#).

³⁹According to information that SEC provided us, 81 of 115 Fair Funds, or 70 percent, have provisions whereby fund proceeds are used to pay administrative expenses. In the remaining 34 cases, the individual or entity sued in the relevant enforcement action, such as a mutual fund company, pay Fair Fund expenses.

administrative expenses charged, Enforcement cannot judge the reasonableness of such fees and take actions as necessary to minimize them.

Enforcement officials generally attributed SEC's inability to implement our 2005 recommendation to changes in priorities for the development of the agency's information systems. After we issued our 2005 report, Enforcement officials said they began working to modify the CATS system so that it could better track Fair Fund administrative expenses and other data. However, SEC ultimately decided to accelerate the development of a new financial management system for the division, called Phoenix. SEC and Enforcement officials said that the agency implemented the first phase of Phoenix in February 2007. The first phase includes limited information relevant to the Fair Fund program (the amount of money ordered in penalties and disgorgement and the amount paid to the agency), but it does not include data on such items as fund administrative expenses. Enforcement officials told us that a second phase of the Phoenix system will contain additional features for more complete management and monitoring of Fair Fund activity, consistent with our 2005 recommendation. According to Enforcement officials, Phoenix II has been funded and is expected to be in place in 2008. Until Phoenix II is implemented and tested, Enforcement officials will continue to lack information necessary for effective Fair Fund management and oversight.

We also note that in the meantime, Enforcement has not leveraged reports that could enhance the division's understanding of Fair Fund expenses, including administrative expenses. SEC rules generally require that final accounting reports be prepared when SEC-overseen Fair Funds are fully distributed and officially closed.⁴⁰ We reviewed four such reports and found that three of them were inconsistent in data reported and did not include comprehensive accounting information. For example, two of the accounting reports did not include complete data on the expenses incurred to administer the Fair Fund plan. Further, senior Enforcement officials said that the division could improve its analysis of information contained in the reports. As a result, Enforcement cannot evaluate the reasonableness of administrative expenses for individual Fair Fund plans

⁴⁰Section 201.1105(f) of title 17 of the Code of Federal Regulations. SEC's Rules of Practice regarding Fair Fund and Disgorgement Plans generally provides, *inter alia*, that "a final accounting shall be submitted for approval of the Commission or hearing officer prior to discharge of the administrator and cancellation of the administrator's bond, if any." SEC also seeks to track activity of court-overseen Fair Funds.

or potentially gain a broader understanding of the reasonableness of such expenses among a variety of plans.

Enforcement Coordinates Its Investigative Activities Internally and with Other Agencies and Is in the Process of Documenting Criminal Referrals

Enforcement has established a variety of processes to coordinate its investigative and law enforcement activities with other SEC offices. Further, Enforcement has established processes to coordinate its investigative activities with other law enforcement agencies, including Justice. However, Enforcement and SEC have not yet implemented our 2005 recommendation that they document referrals of potential criminal activity to other agencies, although plans to do so have been established as part of the division's new investigation management information system (the Hub).⁴¹ Until Enforcement completes this process, its capacity to effectively manage the referral process is limited.

Enforcement Coordinates with Other SEC Units through Regular Meetings and a Referral Process

Enforcement officials said that they hold a variety of meetings periodically to coordinate investigative and other activities within SEC. As discussed previously, senior Enforcement officials said they meet regularly with the SEC Chairman and commissioners to establish investigative priorities. According to the Director of Enforcement, she meets weekly with the heads of other SEC divisions, and other senior division officials said that they meet periodically with their counterparts in other agency units. Enforcement officials cited their coordination with other SEC units on investigations of the backdating of stock options as an example of the agency's successful collaborative efforts.⁴² One Enforcement official said that division staff worked closely with the Office of Economic Analysis to analyze financial data and trends related to options backdating, which allowed them to identify patterns used to target companies for further investigation. This official said that Enforcement also collaborated with

⁴¹[GAO-05-385](#).

⁴²In a typical case, companies misrepresent the date on which stock options were granted (using a date on which the price was lower). When the holders exercise their options, they can realize larger gains because their exercise prices are based on the lower, misrepresented grant date; the company meanwhile doesn't report the larger gains as greater compensation. The practice violates SEC's disclosure and accounting rules, and tax laws.

the Office of the Chief Accountant, the Division of Corporation Finance, and the Office of the General Counsel throughout this effort.

Enforcement officials also said that coordinating their activities with OCIE is particularly important and that the division places a high value on referrals it receives from OCIE regarding potentially illegal conduct. Enforcement officials said that because OCIE staff regularly examine broker-dealers, investment advisers, and other registered entities, they have a broad perspective on compliance with securities laws and regulations. Enforcement officials in SEC's Philadelphia regional office estimated that about 30 or 35 percent of the enforcement actions the Philadelphia office initiates are based on referrals from OCIE staff. They cited one notable recent insider trading case—involving broker-dealer Friedman, Billings, Ramsey & Co., Inc., and which was among the first cases of its kind since the 1980s—as stemming from a referral from an OCIE examination.⁴³

However, other Enforcement officials said that historically they have had some concerns about limitations in information contained in OCIE referrals. These concerns centered on how clearly OCIE identifies potentially improper conduct in its referrals and how much evidence it provides in support of such matters. As a result, in November 2006, OCIE and Enforcement instituted a process that would provide a more formal review of the nature and quality of OCIE referrals. According to OCIE and Enforcement officials, the new procedures expand and formalize a preexisting committee process for reviewing OCIE referrals to Enforcement and communicating the ultimate outcome of those referrals to OCIE. The officials said the revised procedures were instituted to (1) help identify the types of OCIE referrals that were likely (or not) to result in enforcement actions and (2) provide better information to OCIE on the ultimate disposition of its referrals.

Enforcement officials noted that the division receives many more referrals from OCIE than from any other SEC division or office; therefore, developing a formal committee and tracking process for other internal referrals has not been viewed as warranted. SEC also receives referrals from self-regulatory organizations (SRO)—such as what is now the

⁴³*SEC v. Friedman, Billings, Ramsey & Co., Inc.* No. 06-cv-02160 (D.D.C. 2006), SEC Litigation Release No. 19950 (December 20, 2006). According to SEC Release No. 19950, Friedman, Billings, Ramsey, & Co., Inc. agreed to settle the matter without admitting to or denying the allegations.

Financial Industry Regulatory Authority (FINRA)—often involving allegations of insider trading, which are received by Enforcement’s Office of Market Surveillance (OMS).⁴⁴ In a forthcoming report, we assess OMS’s and Enforcement’s processes for reviewing and prioritizing these SRO referrals.

Enforcement Coordinates with Law Enforcement and Other Regulators and Plans to Document Criminal Referrals in New Information Management System

Enforcement officials also said that division staff have established processes to coordinate their investigative activities and working relationships with other law enforcement and regulatory agencies. For example, Enforcement officials in SEC’s regional offices said they have established effective working relationships with U.S. attorney offices to prosecute alleged criminal violations of the securities laws. In our 2005 report, we discussed how Enforcement worked with Justice and state attorneys general to prosecute investment advisers that allegedly violated criminal statutes related to market timing and late trading.⁴⁵ In some cases, Enforcement details investigative attorneys to Justice to assist in the criminal prosecution of alleged securities law violators. Other outside organizations with which SEC and Enforcement coordinate investigative activities include the Federal Bureau of Investigation, federal banking regulators, the Commodity Futures Trading Commission, state securities regulators, and local police. Enforcement also participates in interagency investigative task forces, such as the Corporate Fraud Task Force, the Bank Fraud Enforcement Working Group, and the Securities and Commodities Fraud Working Group.⁴⁶

Additionally, in March 2007, Enforcement held its annual conference at SEC’s Washington headquarters on securities law enforcement, which

⁴⁴FINRA was created in July 2007 through the consolidation of NASD (formerly an SRO) and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange; it is now the largest nongovernmental regulator for all securities firms doing business in the U.S.

⁴⁵[GAO-05-385](#).

⁴⁶The Corporate Fraud Task Force includes a Department of Justice group that focuses on enhancing criminal enforcement internally and an interagency group that focuses on cooperation and joint federal regulatory and enforcement efforts. The Bank Fraud Enforcement Working Group promotes coordination and communication among financial institution regulators and federal law enforcement authorities. The Securities and Commodities Fraud Working Group provides a forum for federal law enforcement authorities to exchange information with securities and commodities regulators, securities SROs, and the Public Company Accounting Oversight Board.

federal and state regulators and law enforcement personnel attended. Topics covered included coordination of SEC investigations with criminal law enforcement agencies and advice on trying a securities case. SEC also conducted sessions on market manipulation, insider trading, financial fraud, stock options backdating, and executive compensation. In September 2007, Enforcement will join other SEC units in hosting the Commission's second Seniors Summit, at which SEC, other regulators, and law enforcement agencies will discuss how to work together to address the growing problem of fraud targeting the nation's senior citizens.

Although Enforcement officials say they are planning to do so, they have not yet fully implemented our 2005 recommendation to document Enforcement's referrals of potential criminal matters—and the reasons for making them—to other law enforcement agencies.⁴⁷ As discussed in that report, SEC has established a policy under which Enforcement attorneys may make referrals on an informal basis to Justice and other agencies with authority to prosecute criminal violations. That is, Enforcement attorneys may alert other agencies to potential criminal activity through phone calls or meetings, and such referrals need not be formally approved by the division or the Commission. We noted that such an informal referral process may have benefits, such as fostering effective working relationships between SEC and other agencies, but also found that Enforcement did not require staff to document such referrals. Appropriate documentation of decision-making is an important management tool. Without such documentation, Enforcement and the Commission cannot readily determine whether staff make appropriate and prompt referrals. Also, the division does not have an institutional record of the types of cases that have been referred over the years. However, Enforcement officials told us that the forthcoming Hub system will include data fields that indicate when informal referrals of potential criminal activity have been made.

Conclusions

In recent years, SEC's Enforcement division and investigative attorneys have initiated a variety of high-profile enforcement actions that resulted in record fines and other civil penalties for alleged serious securities violations and contributed to criminal convictions for the most egregious offenses. While Enforcement has demonstrated considerable success in carrying out its law enforcement mission, some significant limitations in

⁴⁷[GAO-05-385](#).

the division's management processes and information systems have hampered its capacity to operate at maximum effectiveness and use limited resources efficiently. One key reason for these limitations appears to have been Enforcement's management approach, which emphasized a broad delegation of key functions with limited centralized management review and oversight, particularly in the approval and review of new investigations and the administration of the Fair Fund program. Delegation of authority is an important management principle that can foster creativity at the local level and, in the case of Enforcement, likely had some benefits for the investigative process and the administration of the Fair Fund program. However, without well-defined management processes to exercise some control over delegated functions, inefficient program implementation and resource allocation can also occur.

Officials from Enforcement and the Offices of the Chairman and Executive Director have recognized limitations in the division's operations and taken important steps to establish more centralized oversight procedures. In particular, they have centralized the review and approval of new investigations, moved forward to upgrade or replace information systems key to division operations and management, and announced the creation of a new Fair Fund office. However, as described below, these plans require additional actions to fully address identified limitations and maximize the division's operational effectiveness.

- Enforcement has not developed written procedures and criteria for reviewing and approving new investigations. Establishing such guidance would help focus the review of investigations and reinforce the consistency of reviews, as intended by the centralization of this function, and assist in communicating the new policies to all current and new staff. Further, developing written procedures and criteria would establish a transparent and agreed-upon standard for the review and approval of new investigations and thereby facilitate the Commission's ability to oversee and evaluate the division's operations and resource allocation.
- Enforcement has not developed written controls to help ensure the timely and consistent entry of investigative data in the Hub information system, which could increase the risk of misleading or inaccurate management reports being generated by the system. Without written guidance and the establishment of independent and regular reviews of the accuracy of Hub data by division officials, Enforcement is not well positioned to help ensure that it is receiving reliable program information. Further, the lack

of guidance and controls may limit the new system's capacity to better manage the investigation process.

- Enforcement's potentially large backlog of investigations for which closing memoranda and other required administrative procedures have not been completed requires division management's attention. We recognize that clearing this potentially large backlog could pose challenges to Enforcement given the resource commitment that would be required to do so. Nevertheless, leaving such investigations open indefinitely continues to compromise management's ability to effectively manage its ongoing portfolio of cases. Moreover, it has potentially negative consequences for individuals and companies that are no longer under investigation.
- SEC has not yet staffed or defined the roles and responsibilities of the new office that is being established to administer the Fair Fund program. Therefore, it is not possible to determine the extent to which the office may better facilitate the distribution of funds to investors harmed by securities frauds and other violations. While Enforcement awaits the development and implementation of a new information system that would collect comprehensive information on Fair Fund expenses for ongoing plans (for example, administrative expenses), the division has not taken other steps that would, in the meantime, allow it to develop a better perspective on the reasonableness of such expenses. That is, Enforcement has not ensured the consistency of information contained in reports on completed Fair Fund plans or sufficiently analyzed such reports, compromising its capacity to monitor the program.

Given SEC and Enforcement's critical law enforcement mission, it is important that senior officials ensure that weaknesses in their planned improvements be addressed and implementation monitored. Without a full resolution of existing limitations, a significant opportunity to further enhance the division's effectiveness may be missed.

Recommendations for Executive Action

To strengthen Enforcement's management processes and systems and help ensure compliance with securities laws, we recommend that the Chairman of the Securities and Exchange Commission direct the Division of Enforcement and other agency offices, such as the Office of Information Technology or Office of the Executive Director, as appropriate, to take the following four actions:

- establish written procedures and criteria on which to base the review and approval of new investigations;

-
- establish written procedures that reinforce the importance of attorneys entering investigative data into the Hub, provide guidance on how to do so in a timely and consistent way, and establish a control process by which other division officials can independently assess the reliability of investigative data maintained in the system;
 - consider developing expedited administrative and review procedures for closing investigations that have not resulted in enforcement actions and are no longer being actively pursued; and
 - establish and implement a comprehensive plan for improving the management of the Fair Fund program, to include (1) staffing the new central Fair Fund office, defining its roles and responsibilities, and establishing relevant written procedures and (2) ensuring the consistency of and analyzing final accounting reports on completed Fair Fund plans.

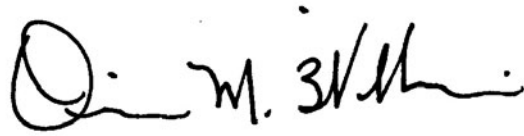
Agency Comments and Our Evaluation

We provided a draft of this report to the Chairman of SEC for comment, and he and the Director of the Division of Enforcement provided written comments that are reprinted in appendix III. In its written comments, SEC agreed with our conclusions and stated it would implement all of our recommendations. Moreover, SEC officials noted that the agency has since established that the new Fair Fund office—referred to as the Office of Distributions, Collections and Financial Management—will be located within the Division of Enforcement. SEC officials said that a senior officer and two assistant directors will lead the operations of the office and the agency is developing the office’s responsibilities. SEC also provided technical comments, which we have incorporated as appropriate.

As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution of this report until 30 days from the report date. At that time, we will provide copies to the Chairman of the Senate Committee on Finance; the Chairman and Ranking Member of the Senate Committee on Banking, Housing, and Urban Affairs; the Chairman and Ranking Member of the House Committee on Financial Services; and other interested committees. We are also sending a copy of this report to the Chairman of the Securities and Exchange Commission. We will make copies available to others upon request. In addition, the report will be available at no charge on our Web site at <http://www.gao.gov>. Contact points for our Offices of Congressional

Relations and Public Affairs may be found on the last page of this report. If you or your staff have any questions about this report, please contact me at (202) 512-8678 or williamso@gao.gov. Key contributors are acknowledged in appendix IV.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Orice M. Williams". The signature is fluid and cursive, with the first name "Orice" being the most prominent.

Orice M. Williams
Director, Financial Markets
and Community Investment

Appendix I: Scope and Methodology

To address our first objective—evaluating the Securities and Exchange Commission (SEC) Division of Enforcement’s (Enforcement) internal processes and information systems for planning, tracking, and closing investigations and planned changes to these processes and systems—we reviewed relevant SEC and Enforcement documentation and data, including the agency’s strategic plan, annual performance reports, performance measurement data, investigation and enforcement action data from the Case Activity Tracking System (CATS), and Enforcement personnel data. We also reviewed guidance on Enforcement’s intranet—EnforceNet—to determine internal procedures for conducting and managing the investigation process and obtained documentation and attended demonstrations for the first phase of Enforcement’s new planned successor system for CATS (the Hub) and for the base model system for the Hub (M&M).¹ We also reviewed prior GAO reports on SEC and Enforcement processes and information technology systems, as well as federal internal control standards.² Further, we interviewed the SEC Chairman, two commissioners, officials from SEC’s Offices of the Executive Director and General Counsel, and Enforcement officials in Washington and the agency’s New York, Boston, and Philadelphia regional offices.

To address our second objective—evaluating the implementation of SEC’s Fair Fund responsibilities—we reviewed a 2005 GAO report that discussed SEC’s Fair Fund process, as well as relevant legislation.³ We also obtained and analyzed summary Fair Fund statistics and documentation and data

¹In 2004, the Boston regional office tasked one of its staff members and an outside consultant to design a new case tracking system for the office. This new database was implemented in 2005 and also piloted in the Los Angeles and Chicago regional offices. When beginning to develop the Hub in 2006, SEC decided to use Boston’s system as the base model for the Hub because of the amount of user input M&M already had received.

²GAO, *Mutual Fund Trading Abuses: SEC Consistently Applied Procedures in Setting Penalties, but Could Strengthen Internal Controls*, [GAO-05-385](#) (Washington, D.C.: May 16, 2005) and *Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (Washington, D.C.: Nov. 1999).

³GAO, *SEC and CFTC Penalties: Continued Progress Made in Collection Efforts, but Greater SEC Management Attention Is Needed*, [GAO-05-670](#) (Washington, D.C.: Aug. 31, 2005).

on individual funds, as provided by Enforcement.⁴ However, Enforcement did not provide data on 24 Fair Fund plans that were identified in our 2005 report. Among the reasons Enforcement officials cited for the omissions were that some of the 24 funds had been fully distributed and thus were not included in an information system established in 2006 that was designed to track only ongoing plans. However, these 24 Fair Fund plans are generally smaller (accounting for about \$118 million or 1 percent of total Fair Funds), and their exclusion does not change our overall conclusion that distributions have been limited.

In addition to Fair Fund data, we reviewed SEC guidance on Fair Funds, including rules on distribution plans, tax treatment, selection of consultants, and distribution procedures. We also reviewed Fair Fund guidance from the U.S. Department of Labor. In addition to discussing the Fair Fund program with relevant SEC and Enforcement officials, we interviewed six consultants hired to design and implement Fair Fund plans, attorneys, consumer advocates, an academic expert, and a representative of a trade group for a retirement plan service provider trade group.

To address the third objective—evaluating Enforcement’s efforts to coordinate investigative activities with other SEC divisions and federal and state law enforcement agencies—we reviewed previous GAO reports on mutual fund trading abuses and Enforcement’s coordination efforts with law enforcement.⁵ We also reviewed relevant SEC documentation, including internal referral policies, and guidance regarding coordination between Enforcement and outside law enforcement authorities. We also attended SEC’s annual securities coordination conference held in Washington in March 2007, which was attended primarily by federal and state regulators and law enforcement personnel. Further, we discussed Enforcement’s coordination efforts with relevant SEC and division officials.

⁴Individual Fair Fund data obtained included information on the type of enforcement action that produced the Fair Fund, type of adjudication, amounts ordered placed into a Fair Fund and amounts distributed, dates of issuance of Fair Fund orders, and whether parties involved were responsible for paying the expenses of their respective Fair Fund plan.

⁵GAO-05-385 and GAO, *U.S. Attorneys: Performance-Based Initiatives are Evolving*, GAO-04-422 (Washington, D.C.: May 28, 2004).

We conducted our work in Washington, D.C.; Boston, Massachusetts; Philadelphia, Pennsylvania; and New York, New York, between November 2006 and July 2007 in accordance with generally accepted government auditing standards.

Appendix II: Selected Division of Enforcement Investigation and Personnel Data

We collected data from the Securities and Exchange Commission (SEC) on the Division of Enforcement’s (Enforcement) investigative caseload and other personnel information (see tables 4-6 below). As shown in table 4, the ratio of ongoing Enforcement investigations to staff attorneys increased substantially from about five investigations per attorney in 2002 to eight per attorney in 2006, according to SEC data. However, these SEC data should be interpreted with caution and may significantly overestimate the number of investigations per Enforcement attorney. The reported number of investigations includes all open investigations at the end of each year, even investigations that have been open for many years. As discussed in this report, Enforcement has not promptly closed many investigations that have not resulted in enforcement actions and are likely no longer being actively pursued. Accordingly, we requested that SEC provide data on the number of ongoing investigations in Enforcement that as of year-end 2006 had been initiated within the previous 2 years. When pending investigations that were more than 2 years old are excluded, the investigation-to-staff-attorney ratio drops to 2.54.¹ While this ratio may provide a more accurate assessment of Enforcement attorneys’ active workloads, individual investigations more than 2 years old could continue to be actively pursued while some individual investigations less than 2 years old may no longer be actively pursued. Enforcement officials estimated that staff attorneys generally can be working on from 3 to 5 investigations at one time, including administering individual Fair Fund plans.

Table 4: Ratio of Open Investigations to Staff Attorneys

2002	2003	2004	2005	2006
5.07	5.43	6.57	7.20	8.06

Source: GAO analysis of SEC data.

Note: Open investigations refer to the number of investigations pending as of the end of each fiscal year according to SEC’s annual reports. Staff attorneys do not include trial attorneys and accountants.

Table 5 shows that the ratio of Enforcement investigative attorneys to paralegals, who provide support to the investigative process, generally

¹We computed this ratio by dividing the number of investigations with a status of “active” in Enforcement’s information system (CATS) that had been open for less than 2 years as of December 31, 2006—1,305—by the number of “staff attorneys” (nonsupervisory investigative attorney positions that SEC personnel data label as “general attorneys”) as of September 31, 2006—514.

**Appendix II: Selected Division of
Enforcement Investigation and Personnel
Data**

declined from 2003 to 2006. Our review of SEC data indicates that the number of Enforcement paralegals increased substantially from 2003 to 2005 (from 58 to 98, or 69 percent) and remained stable in 2006 at 94 (a decline of just over 4 percent). While the number of Enforcement staff and supervisory attorneys also increased from 2003 to 2005 (from 596 to 740, or 24 percent), the rate of increase was not nearly as high as for paralegals. In addition, the number of Enforcement investigative attorneys declined from 740 in 2005 to 684 in 2006, or 8 percent. The relatively slower pace of attorney hiring from 2003 to 2005 and relatively higher rate of attrition in 2006 helps explain why the ratio of attorneys to paralegals has declined in recent years. Other SEC data that we reviewed also indicated a decline in the ratio of investigative attorneys to various types of administrative support staff, such as research specialists, during this period.

Table 5: Ratio of All Investigative (Staff and Supervisory) Attorneys to Paralegals

2002	2003	2004	2005	2006
10.28	11.88	9.00	7.55	7.28

Source: GAO analysis of SEC data.

Note: All investigative attorneys include staff and supervisory attorneys in the Enforcement division. Supervisory attorneys refer to positions that SEC personnel data label as “(supervisory) general attorneys.” This does not include (supervisory) trial attorneys and (supervisory) accountants. SEC personnel data label paralegals as “paralegal specialists.”

Table 6 shows that the ratio of investigative staff attorneys to supervisory attorneys has remained relatively constant. Supervisory attorneys are branch chiefs and assistant directors and do not include attorneys at the associate director level and above.

Table 6: Ratio of Staff Attorneys to Supervisory Attorneys

2002	2003	2004	2005	2006
3.20	3.59	3.50	3.30	3.02

Source: GAO analysis of SEC data.

Appendix III: Comments from the Securities and Exchange Commission

CHRISTOPHER COX
CHAIRMAN

HEADQUARTERS
100 F STREET, NE
WASHINGTON, DC 20549



UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

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SAN FRANCISCO

July 24, 2007

Ms. Orice M. Williams
Director
Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, N.W.
Washington, DC 20548

Dear Ms. Williams:

I appreciate having the opportunity to respond to the GAO's draft report "Additional Actions Needed to Ensure Planned Improvements to Address Limitation in Enforcement Division Operations" (GAO-07-830). The report identifies a number of weaknesses in the Division of Enforcement's processes and systems for planning, tracking, and closing investigations and for managing and distributing Fair Funds to injured investors.

We concur with the GAO's conclusions and with its recommendations for improving the effectiveness of the Commission's enforcement program. We agree with the GAO that improved procedures and systems will allow the Division to more capably manage its operations, to better allocate resources to priority investigations, and to more effectively oversee the prompt distribution of Fair Funds to injured investors. The agency is committed to moving with alacrity to implement each of the GAO's recommendations, as is described in greater detail in the attached letter from the Director of the Division of Enforcement.

Because the senior management of the Division of Enforcement and I both place the highest priority on implementing the GAO's recommendations, I am pleased to report that, two weeks ago, we hosted a meeting of the agency's senior Enforcement management, including the heads of all 11 of the agency's regional offices. We were briefed by the GAO on its findings, and we discussed our commitment to, and our plans for, implementing the GAO's recommended reforms. As we work to implement these recommendations, I would appreciate being able to continue to draw on the GAO's expertise.

Again, thank you, and your staff, for the work you have done on this report, and for your commitment to improving the operations of the Securities and Exchange Commission.

Sincerely,
A handwritten signature in black ink, appearing to read "Chris Cox".

Christopher Cox
Chairman

Enclosure

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Appendix III: Comments from the Securities
and Exchange Commission



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

Division of Enforcement

July 24, 2007

Linda Chatman Thomsen
Director
(202) 551-4894
(202) 772-9279 (fax)
thomsenl@sec.gov

Ms. Orice M. Williams
Director
Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, N.W.
Washington, DC 20548

Re: SEC Enforcement Division Operations

Dear Ms. Williams:

Thank you for the opportunity to review and comment on the draft report concerning the Securities and Exchange Commission's Division of Enforcement's ("Enforcement") processes and systems for conducting investigations and managing the Fair Fund program. The report discusses how Enforcement has taken many positive steps in improving these processes and systems. In addition, the report recommends how we can most effectively manage operations and allocate resources while continuing to meet the goal of deterring securities law violations and returning funds to harmed investors.

I appreciate the collegiality your staff exhibited in preparing the report and in discussing its findings and recommendations with us. We agree with your findings and recommendations and are working with alacrity to implement them.

Our specific comments are as follows:

I. Establish Written Procedures and Criteria Relating to New Investigations

The draft report notes the important steps Enforcement has recently taken to improve the management of its operations by centralizing the review and approval process of new investigations under the two deputy directors' review. This ensures all newly opened MUIs and investigations are an appropriate allocation of resources. The draft report recommends that further action should be taken by Enforcement in the form of establishing written procedures and assessment criteria for reviewing and approving new investigations. We agree with this recommendation and are in the process of developing written procedures and criteria to focus this review and assure that it is consistently applied.

II. Establish Controls to Ensure Reliability of Hub

Your draft report notes that Enforcement has a new investigation information management system, the Hub, which is an interim system designed to aid in the management of Enforcement's investigative process. The report recommends that written procedures be established reinforcing the importance of staff entering investigative data into the Hub in a timely and consistent basis and reviewing the system for reliability. We agree with these findings and recommendations and are working diligently to develop these written procedures.

III. Consider Developing Expedited Procedures for Closing Investigations

Your draft report notes that in the spring, Enforcement began eliminating the backlog of investigations with completed, but unreviewed, closing packages. At this time, Enforcement has successfully eliminated this backlog and developed new procedures to prevent such a backlog from occurring in the future. In addition, your draft report suggests that Enforcement consider developing expedited procedures in another area -- closing investigations that are not likely to result in enforcement actions and for which closing packages have not been completed. We agree that promptly closing investigations that are not actively being pursued can improve the management of the Division and ensure the fair treatment of individuals and companies under its review. Thus, Enforcement plans to actively review these "aged" pending investigations to determine which should be closed and to review our closing process to determine how it can be streamlined.

IV. Establish Comprehensive Plan for Fair Fund Office

The draft report notes that we recently announced our plan to establish a centralized Fair Fund Office and recommends that we implement a plan to staff this new office and develop written procedures to improve the management of the Fair Fund Program. We agree with this recommendation and have determined that this new office will be within the Division of Enforcement and be called the Office of Distributions, Collections and Financial Management. It will be led by a Senior Officer (SO) and two Assistant Directors (SK-17s). The new office will be divided into two groups, each of which will be headed by one of the Assistant Directors -- 1) the Fair Fund Distributions and Collections Unit and 2) the Financial Information Management Unit. We are in the process of fully developing the responsibilities of this office to assure the improved distribution of funds to investors.

The draft report also notes that the SEC has developed a system called Phoenix to manage financial information and that Phoenix will be built-out to include features to manage and monitor Fair Fund activity, including expenses. The second phase of Phoenix will become operational in 2008. The report also recommends that the division take other steps in the meantime that will allow it to develop a better perspective on Fair Fund expenses, including administrative expenses. We agree with this recommendation and will work to standardize the collection of Fair Fund expense data so that it may be analyzed when the system becomes fully operational and will work on developing interim procedures for the staff to review such expenses. When the management of the new Office of Fair Fund Distributions, Collections and

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

3

Financial Management is in place, which is presently anticipated to occur in October 2007, we will make sure that there is appropriate internal reporting on the status of Fair Fund distributions.

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

Yours truly,



Linda Chanen Thomsen
Director

Appendix IV: GAO Contact and Staff Acknowledgments

GAO Contact

Orice M. Williams (202) 512-8678 or williamso@gao.gov

Acknowledgments

In addition to the contact named above, Wesley M. Phillips, Assistant Director; Allison Abrams; Christopher Forsys; Marc Molino; Carl Ramirez; Linda Rego; Barbara Roesmann; and Christopher Schmitt made significant contributions to this report.

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