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ONE HUNDRED NINTH CONGRESS

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October 3, 2005

The Honorable Christopher Cox
Chairman
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

The Honorable David M. Walker
Comptroller General
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Chairman Cox and Mr. Walker:

I am writing with respect to the August 31, 2005, report, SEC and CFTC Penalties: Continued Progress Made in Collection Efforts, but Greater SEC Management Attention Is Needed, GAO-05-670, which was prepared by the U.S. Government Accountability Office (GAO) at the request of Reps. Barney Frank, Paul Kanjorski, and me. This report follows up on open issues from previous reports and (1) discusses the progress of the Securities and Exchange Commission (SEC) in improving its tracking of penalty and disgorgement collection data, (2) assesses the steps SEC has taken to improve collection program management, (3) evaluates SEC's implementation of the Fair Fund provision, section 308 of the Sarbanes-Oxley Act of 2002 (SOX), and (4) describes actions by the Commodity Futures Trading Commission (CFTC) to address previous GAO recommendations.

In the 46-page report that we are releasing today in separate letters, GAO notes on page 1 that: "As part of their responsibility to protect investors, the agencies seek to ensure that individuals who violate federal securities and futures laws and regulations take responsibility for their misdeeds. For their enforcement actions to be successful, however, both agencies must have collection and distribution programs that function effectively." I wholeheartedly agree. GAO has determined that, over the past two years, SEC has undertaken a number of initiatives to enhance its ability to collect and track civil money penalty and disgorgement data and, to a lesser extent, monitor program effectiveness, but more remains to be done (p. 33-34).

As shown in Table 3 on page 22, SEC's penalty collection rate for closed cases between September 2002 and December 2004 ranged from 72 percent and 100 percent and for all cases from 34 percent to 86 percent. These rates represent a significant increase from the 40 percent collection rate for penalties that SEC averaged from January 1997 through August 2002.

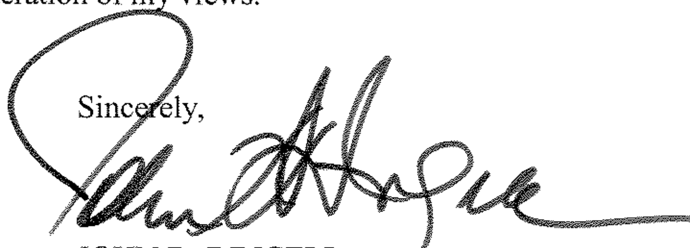
As shown in Table 4 on page 24, for disgorgement levied in closed cases between September 2002 and August 2004, SEC's collection rate ranged from 56 percent to 100 percent and from 13 percent to 34 percent for all cases during the same period. These rates also represent a substantial increase over the collection rate of 14 percent for all cases involving a disgorgement order between 1995 and November 2001.

GAO says that SEC has demonstrated a commitment to effectively implement the Fair Fund provision of SOX, but the program is troubled (pp. 28-32). GAO reports that SEC staff have successfully applied the Fair Fund provision in at least 75 cases since 2002 and that more than $4.8 billion in disgorgements and civil money penalties were designated for return to harmed investors as of April 2005. At the time of GAO's review, although SEC had collected money for 73 of 75 cases that they identified, approximately $60 million from only three cases had been distributed to harmed investors, and funds totaling about $25 million from only one other case were being readied for distribution (p. 29). See also "Plan to Give Defrauded Investors Money From Fines Faces Hurdle," Wall Street Journal, Thursday, July 7, 2005 (enclosure). As a House conferee on this legislation, I am deeply troubled that more money is not being returned to investors. I share GAO's concern that the "SEC may not be able to ensure timely distribution of the growing sum of money that has been collected as a result of the establishment of Fair Funds" (p. 34), and I fully support the efforts of Reps. Frank and Kanjorski to reform this important program and make it more workable.

As shown in Table 2 on page 16, GAO has determined that SEC has taken actions addressing five open recommendations but has not fully addressed three remaining recommendations. First, SEC does not have a formal mechanism to assess whether its collection resources are being used effectively. Second, SEC collection staff pointed to the need for more guidance or training on new collection procedures and data entry protocols to improve the program's effectiveness. Third, GAO found that the two SEC units that are responsible for tracking and maintaining the collection data in the Case Activity Tracking System (CATS) did not always communicate and coordinate with one another on a timely basis. SEC's project for upgrading CATS will not be fully complete until 2008 (p. 12). GAO warns that SEC must take additional steps to improve inadequate controls in the recording and reporting of penalty and disgorgement transactions, as discussed in GAO's recent audit of SEC's financial statements for fiscal year 2004 (p. 9). I commend the SEC for the actions that it has taken, and I agree with the GAO report's recommendations for addressing these matters (p. 35).

Thank you both for your cooperation and attention to this important investor protection issue. This report is the last of the so-called legacy reports. It originated as a 1993 inquiry from this Committee's Subcommittee on Oversight and Investigations (p. 2, footnote 2), and culminates follow-up work on a request that was pending when this Committee's securities jurisdiction was transferred in 2001 to the House Committee on Financial Services. I appreciate the courtesy of the Financial Services Ranking Members with whom I have worked on this matter, and I thank you for your consideration of my views.

Sincerely,



JOHN D. DINGELL
RANKING MEMBER

Enclosures

cc: The Honorable Joe Barton, Chairman
Committee on Energy and Commerce

The Honorable Michael G. Oxley, Chairman
Committee on Financial Services

The Honorable Barney Frank, Ranking Member
Committee on Financial Services

The Honorable Richard H. Baker, Chairman
Subcommittee on Capital Markets,
Insurance, and Government Sponsored Enterprises
Committee on Financial Services

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

Paper Trails

Plan to Give Defrauded Investors Money From Fines Faces Hurdles

New Victim Funds Struggle To Locate Shareholders And Decipher Records

Millions of Pages on WorldCom

By DEBORAH SOLOMON

When Maria Sas sold her house in Sarasota, Fla., in 2000, she put half her money into the stock of telecom highflier WorldCom Inc. When the company imploded in an accounting scandal two years later, Ms. Sas's $43,000 investment was gone.

"That was money I planned to live on," says Ms. Sas, a 47-year-old single mother.

The corporate scandals of a few years ago ravaged the nest eggs of millions of investors. In 2002, Congress stepped in to help, mandating that the Securities and Exchange Commission return fines it collects from wrongdoers to defrauded investors instead of sending the money to the Treasury.

Lawmakers had little idea what a logistical headache they had created. Over the past three years, the SEC has won a series of record settlements from corporate offenders—$750 million from WorldCom, $250 million from Qwest Communications International Inc. and more than $400 million from banks accused of aiding fraud at Enron Corp. In total, the SEC has ordered $5.5 billion in penalties through its "Fair Funds" program.

Return Policy

Much of the money that the SEC has levied since the passage of Sarbanes-Oxley in July 2002 is expected to be returned to investors through the agency's Fair Funds program.

Top five disgorgement/penalty cases since July 2002:

Case	Amount
WorldCom	$750 million
Bank of America	375
Invesco & certain Invesco officers	325.8
Time Warner	300
Qwest	250

Total SEC has levied in penalties and disgorgement:

Year	Amount
FY 2003	$2 billion
FY 2004	3
FY 2005*	2.4

Source: SEC *As of May 23, 2005

But getting the money back to investors has proved to be a huge job and is spawning a bureaucracy all its own. So far, just $82 million, or two cents of every dollar collected, has been returned to investors. Standing in the way are a host of practical and legal issues. (See related article on page D1.)

Under the terms of the SEC settlements, every effort must be made to find investors who were harmed—a higher burden than in some class-action suits, where the onus is often on the investor to participate in the settlement. Simply finding investors is a time-consuming task that requires going through brokerage firms and tracking down shareholders whose addresses have changed. All investor claims must be thoroughly vetted to ensure that money was actually lost and determine how much.

Plans to distribute funds have yet to be set up in some high-profile cases, such as Enron, Qwest and Xerox Corp. The WorldCom fund, one of the biggest and farthest along in its work, could give hints to some of the challenges the other funds will face.

To save money, the WorldCom fund has set up in Syracuse, N.Y., rather than a pricier location such as Manhattan. There, some 50 staff members are reaching out to the millions of investors that held WorldCom's nearly three dozen securities at the time the fraud was revealed.

Some critics have complained about the amount of money being eaten up by administration. One former SEC chairman is getting paid $800 an hour for his services and a former SEC commissioner has received as much as $20,000 per month. Those fees come out of returns being generated by the fund as it awaits distribution.

The government also takes its share of the money. In most cases, restitution funds are placed in an interest-bearing account until distribution with gains taxed at a rate of 35%.

Administrators are "sitting on top of a mountain of money, husbanding it, and it's going to take a long time to get it back to investors," says James D. Cox, a Duke University securities-law professor who has studied class-action settlements.

Kenneth Feinberg, who oversaw the government's $7 billion 9/11 fund and is also administering the Justice Department's $225 million settlement with Computer Associates, says getting money back to victims is complex and time-consuming and rarely makes everyone happy.

Mr. Feinberg said the funds "are difficult, they are complex and there are many ways you can develop formulas for restitution." The key, he says, "is to develop a formula that is credible and relatively fair. It will never please everybody."

SEC officials say the program is new and involves such large amounts of money that it will take time to determine the best way to administer the funds. "The SEC has continued to deter future frauds by making defendants pay fines and cough up their illegal profits, but now we can also help victims by giving them back more of their money," says David Kornblau, chief litigation counsel at the SEC, adding that the cost is "usually only a small percentage of the overall fund."

Investors have long relied on the SEC to help recoup losses. Since the 1970s, the

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Plan to Compensate Bilked Investors Faces Hurdles

Continued From First Page

agency has had authority to force companies and individuals to return to investors "ill-gotten gains"—such as bonuses, profits from stock sales and salaries—in a practice known as disgorgement. It gained broad authority to levy fines in the 1990s.

In the summer of 2002, as Enron and WorldCom were imploding, Congress rushed to introduce a corporate-accountability law that required better financial controls. In addition, a one-sentence provision instructed the agency to return the fines it collects to investors when it also orders disgorgement. The idea was to provide some alternative to private lawsuits, where fees for plaintiffs' lawyers typically eat up one-third of the amount left for shareholders. "When corporate executives make out like bandits, the money ought to go back to the investors, not to trial lawyers," Rep. Michael G. Oxley, co-sponsor of the Sarbanes-Oxley legislation, said as the House discussed the bill, which was passed in July 2002.

The SEC, which doesn't have the resources to run such a program, often farms out oversight of these funds to "distribution administrators"—lawyers, academics and others paid to help find investors, process claims and distribute the money. The administrators are usually overseen by the federal judge in charge of the case.

WorldCom, which changed its name to MCI after emerging from bankruptcy-court protection in April 2004, agreed in 2003 to contribute to a fund set up to compensate investors. It provided $500 million in cash and 10 million shares of MCI stock, which then had an estimated value of $250 million.

The federal judge overseeing the case, on the recommendation of the SEC, handed the job of managing the "WorldCom Victim Trust" to Richard Breeden, a former SEC chairman who also serves as WorldCom's corporate monitor. Getting the money back to investors is expected to take close to two years. The effort is complicated by the sheer number of WorldCom investors believed to have lost money—more than 2.5 million—and the method being used to determine those losses. Since November, the fund has received more than 3.4 million pages of documents from about 180,000 investors, fielded about 20,000 phone calls and processed claims from about 6,000 foreign investors, who often submit paperwork in their native language and currency.

To deal with the paperwork, Mr. Breeden's employees spend their days tracking down investors, coaching them through the claims process and reviewing applications to determine who's eligible to receive money.

One of the biggest hurdles has been trying to locate the millions of investors who purchased one of WorldCom's 34 securities during the fraud period, which runs between April 29, 1999, and June 25, 2002.

Most investors buy securities through brokerage firms and their shares are held in "street name," so companies generally don't know the names and addresses of all its individual shareholders. To find harmed WorldCom investors, Mr. Breeden has turned to brokerage firms and a company that helps track down shareholders.

Brokerage houses have given Mr. Breeden address labels for their clients or agreed to mail information on behalf of the Victim Trust. The deadline to submit a claim is Aug. 19.

Thousands of the claim forms sent since November have been returned because of incorrect addresses. Employees spend part of every day using the Internet and calling brokerage firms in search of usable addresses. Mr. Breeden has also hired several college students to continue trolling for addresses this summer. But about 10,000 of the returned letters are considered "missing" investors who are not expected to be found.

Those who do submit claims often need help filling out the 15-page claims form. One man in California had lost his home and his brokerage records in a mudslide. Fund employees were forced to help him patch together his claim the best they could.

The Victim Trust team has had to do some unusual sleuthing. One employee was searching for relatives of a deceased investor by calling people with the same last name in the city where he lived, according to Mr. Breeden's staff. The employee reached the investor's brother, but he refused to tell her the name of the executor of his brother's estate, saying the two had not spoken in 15 years. When the employee persisted, the man hung up.

After the deal with WorldCom was struck, the SEC hired economists to devise a complex formula that determines the harm to each investor based on how far into the fraud they purchased their stock. For instance, an investor who bought WorldCom stock in 1999, when the fraud first began, did not suffer as much as one who bought the stock farther into the fraud. The logic: The stock price in 1999 was based on mostly real results instead of the inflated financials that boosted the stock price in later years.

Investors are never going to be made whole by the SEC's settlement with WorldCom, which is just a small fraction of the billions of dollars investors lost in the fraud. Under the mathematical model set up by the SEC, a person who bought 10,000 shares of WorldCom stock in April 2002 for $25,000—just before the fraud was revealed—would theoretically get back 93%, or $23,250, of their investment. But former

shareholders are unlikely to get those percentages, given the number of investors and the size of the fund. Mr. Breeden will determine how much money investors get back after all the claims are filed.

To calculate the loss, Mr. Breeden's staff must troll through brokerage statements to match every sale with the original purchase price. Complicating matters further, WorldCom split the stock and issued a tracking stock as well as numerous bond issues during the fraud period. The eligible securities involve two classes of common stock, five classes of preferred stocks and 27 bond issues.

Some claims can take days to process, particularly those of day-traders, who were trading rapidly in WorldCom stock while it was riding high. One day-trader submitted a claim listing 164 purchases of WorldCom securities and 40 sale transactions over a two-year period. The 114-page claim took two days to process, as staff tried to match the original purchase price of the shares with the sale price to tally up the loss. (The trader lost about $187,000 after the stock collapsed.)

Richard Breeden

So far, the fund has spent close to $3 million since it was established last year, including more than $1.2 million for postage. Fees for Mr. Breeden and his staff have totaled more than $1 million, according to documents submitted to federal court and SEC.

Mr. Breeden says he personally bills the fund about 10 hours per month, at $800 an hour—25% less than what he normally charges. That comes out to about $8,000 a month. He notes that the fund's costs are being paid with investment income the fund earns through dividends, stock sales and Treasury bills so the principal is protected.

"The total cost for a highly accurate and fully documented distribution will be a small percentage of the income from the fund," he says—about $4 or $5 per victim. Mr. Breeden says he's tried to keep costs as low as possible by setting up the fund's claims-processing facility in Syracuse, where rent and labor is cheaper.

The trust also pays an "equity manager" who oversees the 10 million shares of MCI stock contributed to the fund. Based on recommendations from the SEC, the judge hired J. Carter Beese, who served as an SEC commissioner from 1992 to 1994 and in recent years has been a senior executive and director of Riggs National Corp.

Mr. Beese's job is selling off the stock in an orderly manner while preserving as much value for WorldCom's fraud victims as possible. He was initially paid $20,000 a month, but the amount was recently reduced to $7,000 a month after the sale of stock reduced the value of the portfolio.

Some observers question the fees paid to the manager, which SEC officials say is commensurate with what the manager of a mutual fund of similar size would receive.

"There ought to be a different level of compensation when you're not taking any personal financial risk," says Barbara Roper, head of investor protection at the Consumer Federation of America, an advocacy group.

Mr. Beese said his compensation is "a standard fee."

Regulators are looking for cheaper and faster ways to get money back to investors. While the Fair Funds program was set up to be separate from private class-action lawsuits, the SEC is moving to work more closely with trial lawyers and has hitched several of its Fair Fund efforts to related class-action settlements that cover a similar set of investors.

SEC funds have been combined with class-action settlements in about a half-dozen cases, including the agency's $150 million settlement with Bristol-Myers Squibb Co. and its $25 million settlement with Lucent Technologies Inc. None of the SEC's settlement funds are used to pay attorneys' fees, says Mr. Kornblau of the SEC.

SEC officials say the coupling of Fair Funds payouts with class-action settlements can help investors can get their money back more quickly and with fewer costs than in a case like WorldCom, where an entire infrastructure had to be created from scratch.

Maria Sas, who was unaware of the SEC's settlement fund until asked about it by a reporter, says she plans to submit a claim. She's already filed papers to take advantage of a separate class-action settlement.

Ms. Sas, a self-employed employee-benefits consultant with a 5-year-old son, says she had hoped to make a profit on WorldCom and eventually sell her shares to help pay for day-to-day costs, such as health insurance.

After losing her money, Ms. Sas says she pulled out of the stock market entirely because of fears that fraud would surface at other companies in which she had invested. "I liquidated every stock I owned, including my pension, because I have no control," she says. "I hope I get something back."