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SECURITIES AND EXCHANGE COMMISSION

Greater Attention Is Needed to Enhance Communication and Utilization of Resources in the Division of Enforcement

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Highlights

Highlights of GAO-09-613T, a testimony before the Subcommittee on Securities, Insurance, and Investment, Senate Committee on Banking, Housing, and Urban Affairs

Why GAO Did This Study

In recent years, questions have been raised about the capacity of the Securities and Exchange Commission's (SEC) Division of Enforcement (Enforcement) to manage its resources and fulfill its law enforcement and investor protection responsibilities. This testimony focuses on (1) the extent to which Enforcement has an appropriate mix of resources; (2) considerations affecting penalty determinations, and recent trends in penalties and disgorgements ordered; and (3) the adoption, implementation, and effects of recent penalty policies. The testimony is based on the GAO report, *Securities and Exchange Commission: Greater Attention Needed to Enhance Communication and Utilization of Resources in the Division of Enforcement* (GAO-09-358, March 31, 2009). For this work, GAO analyzed information on resources, enforcement actions, and penalties; and interviewed current and former SEC officials and staff, and others.

What GAO Recommends

GAO made several recommendations, including that the SEC Chairman (1) further review the level and mix of Enforcement resources, and assess the impact of the division's internal case review process; (2) examine whether the 2006 corporate penalty policy is achieving its intended goals; and (3) take steps to ensure appropriate staff participation in policy development and review. SEC agreed with the recommendations.

To view the full product, including the scope and methodology, click on GAO-09-613T. For more information, contact Orice Williams at 202-512-8678 or williamso@gao.gov.

What GAO Found

Recent overall Enforcement resources and activities have been relatively level, but the number of investigative attorneys decreased 11.5 percent over fiscal years 2004 and 2008. Enforcement management said resource levels have allowed them to continue to bring cases across a range of violations, but both management and staff said resource challenges have delayed cases, reduced the number of cases that can be brought, and potentially undermined the quality of some cases. Specifically, investigative attorneys cited the low level of administrative, paralegal, and information technology support, and unavailability of specialized services and expertise, as challenges to bringing actions. Also, Enforcement staff said a burdensome system for internal case review has slowed cases and created a risk-averse culture. SEC's strategic plan calls for targeting resources strategically, examining whether positions are deployed effectively, and improving program design and organizational structure. Enforcement management has begun examining ways to streamline case review, but the focus is process-oriented and does not give consideration to assessing organizational culture issues.

A number of factors can affect the amount of a penalty or disgorgement that Enforcement staff seek in any individual enforcement action, such as nature of the violation, egregiousness of conduct, cooperation by the defendant, remedial actions taken, and ability to pay. In 2006, the Commission adopted a policy that focuses on two factors for determining corporate penalties: the economic benefit derived from wrongdoing and the effect a penalty might have on shareholders. In 2007, the Commission adopted a policy, now discontinued, that required Commission approval of penalty ranges before settlement discussions. Setting aside the effect of any policies, total penalty and disgorgement amounts can vary on an annual basis based on the mix of cases concluded in a particular period. Overall, penalties and disgorgements ordered have declined significantly since the 2005-2006 period. Total annual penalties fell 84 percent, from a peak of $1.59 billion in fiscal year 2005 to $256 million in fiscal year 2008. Disgorgements fell 68 percent, from a peak of $2.4 billion in fiscal year 2006 to $774.2 million in fiscal year 2008.

Enforcement management, investigative attorneys, and others agreed that the two recent corporate penalty polices—on factors for imposing penalties, and Commission pre-approval of a settlement range—have delayed cases and produced fewer, smaller penalties. GAO also identified other concerns, including the perception that SEC had "retreated" on penalties, and made it more difficult for investigative staff to obtain "formal orders of investigation," which allow issuance of subpoenas for testimony and records. Our review also showed that in adopting and implementing the penalty policies, the Commission did not act in concert with agency strategic goals calling for broad communication with, and involvement of, the staff. In particular, Enforcement had limited input into the policies the division would be responsible for implementing. As a result, Enforcement attorneys reported frustration and uncertainty in application of the penalty policies.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the results of our recent study of the U.S. Securities and Exchange Commission (SEC) Division of Enforcement (Enforcement).[1] The division plays a key role in helping the agency meet its mission of protecting investors and maintaining fair and orderly markets. Current economic conditions and recent turmoil in financial markets have underscored the importance of Enforcement's role. Each year, Enforcement brings hundreds of civil enforcement actions against individuals and companies accused of violating securities laws. However, we and others have criticized Enforcement's capacity to effectively manage its activities and fulfill its critical law enforcement and investor protection responsibilities on an ongoing basis. As you know, the alleged Madoff fraud—described as the largest Ponzi scheme in history—and the failure of Enforcement to detect the fraud during prior investigation of the firm have increased concerns about the adequacy of SEC's enforcement efforts.

This statement is based on our March 31, 2009 report, and focuses on: (1) the extent to which Enforcement has an appropriate mix of resources dedicated to achieving its objectives, including support staff, information technology, and access to specialized services; (2) the factors that influence the amount of penalties and disgorgements that are ordered and the total amount of these remedies in recent years; and (3) the adoption, implementation, and effects of two recent policies for determining corporate penalties.

To address our objectives, we analyzed information on trends in SEC resources, enforcement actions, and penalties, and reviewed relevant documents on the corporate penalty policies. We also met with SEC officials, former SEC commissioners, current and former Enforcement staff, and outside parties knowledgeable about Enforcement practices, such as securities defense attorneys and academics who study the securities industry and SEC. We held 11 small group meetings with a total of more than 80 front-line Enforcement staff—investigative attorneys, and first-level supervisors, known as branch chiefs—in four SEC offices across

[1]GAO, *Securities and Exchange Commission: Greater Attention Needed to Enhance Communication and Utilization of Resources in the Division of Enforcement*, GAO-09-358 (Washington, D.C.: Mar. 31, 2009).

the country (Chicago, San Francisco, New York, and Washington, D.C.).[2] We undertook this performance audit in accordance with generally accepted government auditing standards. These standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Summary

Overall Enforcement resources and activities have been relatively level recently, but the number of non-supervisory investigative attorneys decreased 11.5 percent during fiscal years 2004 through 2008. Enforcement management said resource levels have not prevented the division from continuing to bring cases across a range of violations, but both management and staff said resource challenges have delayed cases, reduced the number of cases that can be brought, and potentially undermined the quality of some cases. Specifically, investigative attorneys cited the low level of administrative, paralegal, and information technology support, and unavailability of specialized services and expertise. Also, Enforcement staff said a burdensome system for internal case review has slowed cases, and that there is a culture of risk aversion. SEC's strategic plan calls for targeting resources strategically, examining whether positions are deployed effectively, and improving program design and organizational structure. Enforcement management has begun examining how to streamline case review, but their focus is on process and does not give consideration to assessing organizational culture issues. To address these issues, we recommended that the Chairman further review the level and mix of resources dedicated to Enforcement, and assess the impact that the division's current review and approval process for investigative staff work has on organizational culture and the ability to bring timely enforcement actions.

A number of factors can affect the amount of a penalty or disgorgement that Enforcement staff seek in any individual enforcement action. For example, staff consider the nature of the violation, egregiousness of conduct, cooperation by the defendant, remedial actions taken, and ability to pay. In 2006, the Commission adopted a policy that focuses on two

[2]In this testimony, we collectively refer to investigative attorneys and branch chiefs with whom we spoke as "investigative attorneys." Also, while we spoke to a variety of Enforcement staff in small group meetings, the comments we received are not necessarily representative of the beliefs of all staff.

factors for determining corporate penalties: the economic benefit derived from wrongdoing and the effect a penalty might have on shareholders. In 2007, the Commission adopted a policy, now discontinued, that required Commission approval of penalty ranges before settlement discussions. Setting aside the effect of any policies, penalty and disgorgement amounts can vary on an annual basis based on the mix of cases concluded in a given period. However, overall penalties and disgorgements ordered have declined significantly since the 2005 through 2006 period. Penalties fell 84 percent, from a peak of $1.59 billion in fiscal year 2005 to $256 million in fiscal year 2008. Disgorgements fell 68 percent, from a peak of $2.4 billion in fiscal year 2006 to $774.2 million in fiscal year 2008.

Enforcement management, investigative attorneys, and others agreed that the two recent corporate penalty polices—on factors for imposing penalties, and Commission pre-approval of a settlement range—have, as implemented, delayed cases and produced fewer, smaller penalties. We identified other concerns, including the perception by some that SEC had "retreated" on penalties and made it more difficult for investigative staff to obtain "formal orders of investigation," which allow for issuance of subpoenas for testimony and records. Our review also showed that in adopting and implementing the penalty policies, the Commission did not act in concert with agency strategic goals calling for broad communication with, and involvement of, the staff. In particular, Enforcement had limited input into the policies it would be responsible for implementing. As a result, Enforcement attorneys reported frustration and uncertainty in applying the penalty policies. To begin to address these issues, we recommended that the Chairman determine if the 2006 corporate penalty policy is achieving its stated goals, and any other effects the policy may have had in adoption or implementation. We also recommended that the Chairman take steps to ensure that the Commission, in creating, monitoring, and evaluating its policies, adheres to its strategic goal and follows other best practices for communication with, and involvement of, the staff affected by such changes.

Background

SEC is an independent agency created to protect investors; maintain fair, honest, and efficient securities markets; and facilitate capital formation. SEC's five-member 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. Enforcement staff located in headquarters and 11 regional offices conduct investigations through informal inquiries, interviews of

witnesses, examination of brokerage records, reviews of trading data, and other methods.[3] At the request of Enforcement staff, the Commission may issue a formal order of investigation, which allows the division's staff to compel witnesses by subpoena to testify and produce books, records, and other documents. Following an investigation, SEC staff present their findings to the Commission for its review, recommending Commission action either in a federal court or before an administrative law judge. On finding that a defendant has violated securities laws, the court or the administrative law judge can issue a judgment ordering remedies, such as civil monetary penalties and disgorgement. In many cases, the Commission and the party charged decide to settle a matter without trial. In these instances, Enforcement staff negotiates settlements on behalf of the Commission.

Investigative Staffing Has Fallen and Resource Challenges Undermine the Ability to Bring Enforcement Actions

Total Enforcement staffing has declined 4.4 percent, from a peak of 1,169 positions in fiscal year 2005 to 1,117 positions in fiscal year 2008.[4] While overall Enforcement resources and activities have remained relatively level in recent years, the number of non-supervisory investigative attorneys, who have primary responsibility for developing enforcement cases, decreased by 11.5 percent, from a peak of 566 in fiscal year 2004 to 501 in fiscal year 2008. Enforcement management attributed this greater decline to several factors: promotion of staff attorneys into management during a hiring freeze, which left their former positions vacant; diversion of investigative positions to other functions; and reduction of opportunities for non-attorney support staff to move to positions outside the agency.

At the same time, staff turnover has decreased and staff tenure increased. The majority of Enforcement's non-supervisory attorney workforce has 10 years of experience or less, but the distribution of experience in this category has reversed in recent years. The portion with less than 3 years of experience has declined by about 50 percent, and the portion with 3 to less than 10 years of experience has increased by about 55 percent. The portion with 10 to less than 15 years, while small overall, has grown by

[3]The Commission delegates various authorities to the Director of Enforcement, such as instituting subpoena enforcement proceedings in federal court or demanding production of various records. *See* 17 C.F.R. § 200.30-4(10).

[4]After the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002), increased SEC's appropriations authorization, Enforcement staffing increased before subsequently declining. In fiscal year 2008, staffing increased, but remained below the post-Sarbanes-Oxley peak.

about 14 percent. Enforcement management welcomed these trends, but believed they resulted from a weaker private-sector job market for attorneys. They felt that had market conditions been better recently, departures would have been more numerous, which would have depressed the experience level.

Measured by the number of enforcement cases opened and number of enforcement actions brought annually, Enforcement activity has been relatively level in recent years. Case backlog has declined somewhat as the division has made case closings a greater priority. Nevertheless, Enforcement management and investigative attorneys agreed that resource challenges have affected their ability to bring enforcement actions effectively and efficiently. Enforcement management told us that the current level of resources has not prevented the division from continuing to bring cases across a range of violations. But management and staff acknowledged that current staffing levels mean some worthwhile leads cannot be pursued, and some cases are closed without action earlier than they otherwise would have been. More specifically, investigative attorneys cited the low level of administrative, paralegal, and information technology support, unavailability of specialized services and expertise, and a burdensome system for internal case review as causing significant delays in bringing cases, reducing the number of cases that can be brought, and potentially undermining the quality of cases. Enforcement management concurred with the staff's observations that resource challenges undercut enforcement efforts. Effective and efficient use of resources is important to accomplishing Enforcement's mission. SEC's strategic plan calls for targeting resources strategically, examining whether positions are deployed effectively, and exploring how to improve program design and organizational structure. Some attorneys with whom we spoke estimated that they spend as much as a third to 40 percent of their time on the internal review process. Recently, Enforcement management has begun efforts that seek to streamline the case review process. The initiative focuses on process, but our review suggests that organizational culture issues, such as risk aversion and incentives to drop cases or narrow their scope, are also present. If the division does not consider such issues in its initiative, it may not be as successful as it otherwise could be.

Various Factors Affect the Amount of Penalties and Disgorgements Ordered, While Overall, Total Amounts Have Declined in Recent Years

Enforcement staff consider a number of factors when determining the dollar amounts of penalties and disgorgements, which in total have declined in recent years. To determine a penalty in an individual case, Enforcement staff consider factors such as the nature of the violation, egregiousness of conduct, cooperation by the defendant, remedial actions taken, and ability to pay. Disgorgement is intended to recover ill-gotten gains made, or losses avoided, through a defendant's actions. In 2006 and 2007, the Commission articulated certain policies for determining the appropriateness and size of corporate penalties. The 2006 policy—which the Commission said was based in part on the legislative history of a 1990 act that provided SEC with civil penalty authority—established nine factors for evaluating imposition of corporate penalties, but said two were of primary importance: (1) direct benefit to the corporation and (2) additional harm to shareholders.[5]

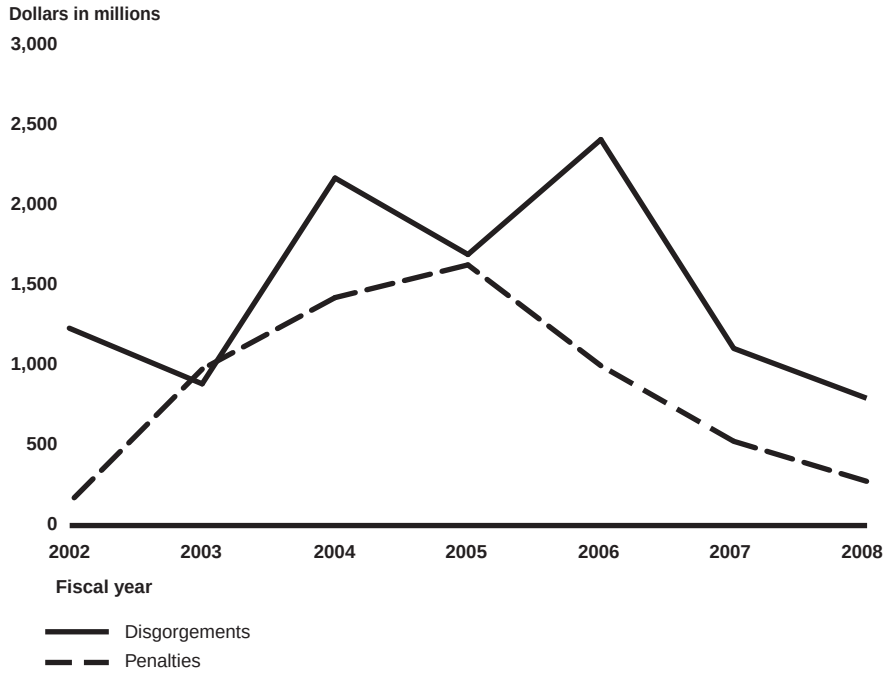
The 2007 policy, now discontinued, required Enforcement staff, when contemplating a corporate penalty, to obtain Commission approval of a penalty range before settlement discussions could begin. Cases that subsequently were settled within the range specified by the Commission were eligible for approval on an expedited basis. At the same time the Commission provided the settlement range, it also granted Enforcement staff authority to sue. According to Enforcement staff and former commissioners with whom we spoke, and as stated by the then-Chairman, the purpose of the policy, also known as the "pilot program," was to:

[5]*See* SEC, *Statement of the Securities and Exchange Commission Concerning Financial Penalties* (Jan. 4, 2006). In this statement, the Commission noted that SEC's authority to impose civil penalties was relatively new and that existing SEC penalty cases did not provide a clear public view of when and how the Commission would seek civil penalties against corporations. In describing a particular framework that it followed for penalty determinations in two cases, the Commission said it relied on the legislative history of the Securities Enforcement Remedies and Penny Stock Reform Act, Pub. L. No. 101-429, 104 Stat. 931 (Oct. 15, 1990). The act provided SEC general authority to seek civil money penalties in enforcement cases. Prior to this act, the SEC's authority to seek civil penalties was generally limited to cases filed in district court for insider trading violations. In its January 2006 statement, the Commission identified factors from the statute and its legislative history pertinent to the analysis of corporate issuer penalties, with the first two being of principal consideration: (1) the presence or absence of a direct benefit to the corporation as a result of the violation; (2) the degree to which the penalty will recompense or further harm the injured shareholders; (3) the need to deter the particular type of offense; (4) the extent of the injury to innocent parties; (5) whether complicity in the violation is widespread throughout the corporation; (6) the level of intent on the part of the perpetrators; (7) the degree of difficulty in detecting the particular type of offense; (8) presence or lack of remedial steps by the corporation; and (9) the extent of cooperation with Commission and other law enforcement.

- provide earlier Commission involvement in the penalty process;
- strengthen Enforcement staff's negotiating position; and
- maintain consistency, accountability, and due process.

Setting aside the effect of the implementation of any policy, the total amount of penalties and disgorgement ordered on an annual basis can vary according to the type and magnitude of cases concluded in a given period. As shown in figure 1, since reaching peaks in fiscal years 2005 and 2006, total annual penalty and disgorgement amounts have declined. While both penalties and disgorgements fell in recent years, penalties have been declining at an accelerating rate, falling 39 percent in fiscal year 2006, another 48 percent in fiscal year 2007, and then 49 percent in fiscal year 2008. Also, penalties declined in the aggregate by a greater amount than disgorgements. In particular, penalties fell 84 percent, from a peak of $1.59 billion in fiscal year 2005 to $256 million in fiscal year 2008. Disgorgements fell 68 percent, from a peak of $2.4 billion in fiscal year 2006 to $774.2 million in fiscal year 2008.

Figure 1: Dollar Totals of Penalties and Disgorgements, Fiscal Years 2002 through 2008



Source: SEC.

Compared to fiscal year 2006, SEC brought more corporate penalty cases in fiscal 2007, but for smaller amounts. In 2007, SEC brought 10 cases, compared to 6 in 2006. Four of the six cases in 2006 resulted in penalties of $50 million or more, with the two largest, American International Group, Inc. and Fannie Mae, totaling $100 million and $400 million, respectively. In contrast, in the fiscal year 2007 cases, only two issuers, MBIA, Inc., and Freddie Mac, were assessed penalties of at least $50 million.[6]

The distribution of enforcement actions by type of case generally has been consistent in recent years. Enforcement management said that the division has met its goal that a single category of cases not account for more than 40 percent of all actions.

[6]The parties settled without admitting or denying the charges.

Recent Corporate Penalty Policies—Adopted and Implemented with Only Limited Communication—Have Delayed Cases and Discouraged Penalties

We found that Enforcement management, investigative attorneys, and others concurred that the 2006 and 2007 penalty policies, as applied, have delayed cases and produced fewer and smaller corporate penalties. On their face, the penalty policies are neutral, in that they neither encourage nor discourage corporate penalties. However, Enforcement management and many investigative attorneys and others said that Commission handling of cases under the policies both transmitted a message that corporate penalties were highly disfavored and caused there to be fewer and smaller corporate penalties.

According to a number of Enforcement attorneys and division managers, investigative attorneys began avoiding recommendations for corporate penalties. For example, when the question of whether to seek a corporate penalty is a close one, the staff will default to avoiding the penalty. Or, if investigative staff decides to seek a penalty, they will change their focus from pursuing what they otherwise would recommend as most appropriate to tailoring recommendations to what they believe the Commission will find acceptable. According to many investigative attorneys, the penalty policies contributed to an adversarial relationship between Enforcement and the Commission, where some investigative attorneys came to see the Commission less as an ally and instead more as a barrier to bringing enforcement actions.

Enforcement management told us they concurred with these observations about the effect of the application of the penalty policies. Although the Commission never directed there be fewer or smaller penalties, the officials said this has been the practical effect because Commission handling of cases made obtaining corporate penalties more difficult. Over time, the officials said they struggled with implementation and were unable to provide guidance to the staff, because they saw the Commission's application of the penalty factors as inconsistent. Furthermore, the widely held view in Enforcement was that the unstated purpose of the 2006 policy was to scale back corporate penalties.

Our review identified several other concerns voiced by Enforcement staff and others:

- That the policies have had the effect of making penalties less punitive in nature—by conditioning corporate penalties in large part on whether a corporation benefited from improper practices, penalties effectively become more like disgorgement.
- That the 2007 policy (Commission pre-approval of a settlement range) could have led to less-informed decisions about corporate penalties. That

is, the Commission would decide on a penalty range in advance of settlement discussions, when settlement discussions themselves can reveal relevant information about the conduct of the wrongdoer.

- That the policies have reduced incentives for subjects of enforcement actions to cooperate with the agency, because of the perception that SEC has retreated on penalties.

- That it became more difficult to obtain formal orders of investigation, which allow issuance of subpoenas to compel testimony and produce books. Since fiscal year 2005, the number of formal orders approved by the Commission has decreased 14 percent.

Our review also showed that in adopting and implementing the 2006 and 2007 corporate penalty policies, the Commission did not act in concert with agency strategic goals calling for broad communication with, and involvement of, the staff. In particular, Enforcement, which is responsible for implementing the policies, had only limited input into their development. According to Enforcement management, the broad Enforcement staff had no input into either policy. Senior division management did have input into the 2006 policy, but none into the 2007 policy. As a result, Enforcement attorneys say there has been frustration and uncertainty about application of the penalty policies.

Mr. Chairman, this concludes my prepared statement. I would be happy to respond to any questions that you or other members of the subcommittee might have.

Contacts

For further information on this testimony, please contact Orice M. Williams at (202) 512-8678 or williamso@gao.gov, or Richard J. Hillman at (202) 512-8678 or hillmanr@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Individuals making key contributions to this testimony include Karen Tremba, Assistant Director and Christopher Schmitt.

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