



U.S. Securities and Exchange Commission

Office of Inspector General

Office of Audits

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# Division of Enforcement's Disgorgement Waivers





OFFICE OF  
INSPECTOR GENERAL

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

## MEMORANDUM

February 3, 2009

**To:** Linda Thomsen, Director, Division of Enforcement

**From:** H. David Kotz, Inspector General

**Subject:** *Audit of Disgorgement Waivers*, Report No. 452

This memorandum transmits the Securities and Exchange Commission, Office of Inspector General's (OIG) final report detailing the results of our contractor's audit on Enforcement's Disgorgement Waiver process.

The final report consists of 8 recommendations that are addressed to the Division of Enforcement. In response to the draft report, responsible management officials concurred with all 8 recommendations.

Your written responses to the draft report, dated February 3, 2009, are included in their entirety in Appendix IV. In addition, OIG's response to management's comments are included in Appendix V.

Should you have any questions regarding this report, please do not hesitate to contact me. During this audit we appreciate the courtesy and cooperation that you and your staff extended to our contractors.

### Attachment

cc: Peter Uhlmann, Chief of Staff, Chairman's Office  
Diego Ruiz, Executive Director, Office of the Executive Director  
George Curtis, Deputy Director, Division of Enforcement  
Scott Friestad, Deputy Director, Division of Enforcement  
Joan McKown, Chief Counsel, Division of Enforcement  
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Michelle Barrans, Senior Attorney, Division of Enforcement  
Darlene L. Pryor, Management Analyst, Office of the Executive Director

Rick Hillman, Managing Director of Financial Markets and Community Investment, GAO

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## EXECUTIVE SUMMARY

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Regis & Associates, PC, under contract with the U.S. Securities and Exchange Commission's (the Commission)<sup>1</sup> Office of Inspector General, reviewed the Commission's Division of Enforcement's (Enforcement) Disgorgement Waivers, granted in fiscal years 2006 through 2008. The Office of Inspector General (OIG) was established in March 1989, as required by the Inspector General Act of 1978, as amended. The mission of the OIG is to promote, the integrity, efficiency and effectiveness of the critical programs and operations of the Commission. The OIG independently decides which matters it will audit and investigate.

The OIG conducted an audit of Enforcement's disgorgement waivers from November 1999 through June 2000 (Disgorgements, Audit 311). The OIG's audit found that improvements were needed in the waiver process in order to ensure that the recommended waivers were justified. The OIG's report recommended that Enforcement establish an effective organizational structure for reviewing disgorgement waiver requests, hire a contractor to review waiver requests, and evaluate the findings and recommendations provided by the contractor.

The OIG conducted a follow-up audit of Enforcement's disgorgement waivers from June 2004 to December 2004 (Disgorgements, Audit 384) to evaluate the adequacy of Enforcement's written procedures for the waiver process, and to determine the extent of compliance with those procedures. The follow-up audit (Audit 384) found that further improvements were still needed in the internal controls and guidance for reviewing disgorgement waivers. Specifically, the follow-up audit noted instances where Enforcement's staff did not obtain the required information to corroborate a defendant/respondent's financial statement assertions (e.g., credit reports, income tax returns, Lexis/Nexis or other Internet searches). Additionally, the OIG follow-up audit found that Enforcement's guidance did not clearly state whether certain steps were required or optional, and did not provide guidance on the handling of cases where defendants/respondents did not provide the requested documentation. The OIG follow-up audit report contained several recommendations, including that: Enforcement should implement adequate internal controls to ensure that all required documentation such as tax returns, database searches, and credit reports be obtained and reviewed by a Supervisor; Enforcement should consider making the Checklist a mandatory item to be completed and placed in the waiver file; and Enforcement should implement adequate internal control policies and procedures to ensure that that the staff attorneys are trained in the disgorgement waiver process.

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<sup>1</sup> See Acronyms used in Appendix I.

OIG's current audit found that while progress has been made in Enforcement's disgorgement waiver process, some concerns (including some deficiencies that the OIG previously identified), remain. Our review consisted of 63 investigations where 72 defendants/respondents received disgorgement waivers totaling \$123,070,681.52 that originated between October 1, 2005 and May 31, 2008 based on their inability to pay.

The results of our audit are as follows. Our review has identified three cases in which full waivers were granted, totaling \$841,580, even though the defendants/respondents appeared to have the ability to pay at least some portion of the disgorgement amounts and thus, either partial payment and/or a payment plan should have been considered. Specifically, we determined that these defendants/respondents had substantial assets, good credit scores, positive net worth, and/or positive monthly net income.

The audit also revealed two instances where the assets were not accurately reported on the sworn financial statements (SFS). The SFS, submitted by defendants/respondents, are the foundational documents in the disgorgement waiver review process. These documents state the assertions of the defendants/respondents regarding their assets, income, liabilities, and expenses.

Specifically, we identified two defendants/respondents who underreported assets totaling at least \$386,237.78. Our analysis is based on the inability to reconcile the amounts reported on the SFS to the corresponding supporting documentation and information obtained through public database searches.

In addition, our review found that in 56 instances, Enforcement did not follow its procedures requiring its staff to obtain adequate supporting documentation for the dollar amounts on the defendants/respondents' SFS.<sup>2</sup> In addition, the staff did not document why certain procedures were not followed (e.g., why certain documentation was not obtained). Following these procedures is important because it helps ensure that waiver requests are only granted to persons with a proven inability to pay.

Assets such as cash, securities, real estate, automobiles, and notes receivable, reported on the SFS for seven defendants/respondents, were not supported by documentation, such as bank statements and asset titles. The liabilities reported on the SFS for 21 defendants/respondents were not supported by documentation, such as mortgage statements and credit card statements. Furthermore, income and expense information reported on the SFS were not always supported by the needed documentation.

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<sup>2</sup> Some individuals may be listed more than once because we found missing documentation with respect to their income and expenses, for instance.

The review found one instance where the SFS was apparently not prepared or provided to us. Also, the SFS for one defendant/respondent was not signed and notarized.

The audit further found 24 instances where the checklists that are required for maintaining, reviewing and confirming the SFS were either not provided in the file, or not signed as required. We also found 34 instances where credit reports, bank statements and income tax returns were not provided or obtained, or signed as required.

The review further found that Enforcement had no formal or comprehensive training programs for the staff who are responsible for reviewing the disgorgement waiver requests. The provision of formal training for those staff would provide them with a comprehensive understanding regarding the disgorgement waiver review process. Given the complexity and the level of sensitivity, it is critical that the staff who review waiver requests are provided with the requisite resources, including adequate training in new technology, skills, and applicable regulatory standards.

The audit report contains eight recommendations,<sup>3</sup> including that: Enforcement ensure that staff comply with its procedures and consider partial payments plans and partial waivers where defendants/respondents have the ability to pay some portion of the disgorgement amount; ensure review of defendants/respondents' financial information for accuracy prior to recommending a disgorgement waiver; clarify its policies regarding when supporting documentation should be obtained; implement adequate internal controls to ensure that all required documentation such as tax returns, database searches, and credit reports be obtained and reviewed by a supervisor; and implement adequate internal control policies and procedures to ensure that the staff attorneys are trained in the disgorgement waiver process.

Based on our review, we noted total cost savings amounting to \$386,237.78 represented underreported assets. These figures are detailed and reported in Appendix II of this report.

The findings and issues noted above are discussed in detail in this report. The report provides eight recommendations, which if implemented, would help improve controls over the granting of disgorgement waivers.<sup>4</sup>

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<sup>3</sup> See Appendix III for a list of the recommendations.

<sup>4</sup> Management's comments are attached in Appendix IV and our response is in Appendix V.

## TABLE OF CONTENTS

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<b>EXECUTIVE SUMMARY</b> .....	i
<b>INTRODUCTION</b> .....	1
Background.....	1
Objectives, Scope, and Methodology .....	4
<b>FINDINGS AND RECOMMENDATIONS</b> .....	9
<b>APPENDIX</b>	
Appendix I – Acronyms Used.....	38
Appendix II – Schedule of Cost Savings.....	39
Appendix III – List of Recommendations .....	40
Appendix IV – Management Comments .....	42
Appendix V – OIG Response to Management Comments .....	61
Appendix VI – Criteria.....	63

# INTRODUCTION

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## Background

The Securities and Exchange Commission (the Commission) is a United States government agency, created by Congress to enforce the federal securities laws and regulate the securities market. The Commission was created by Section 4 of the Securities Exchange Act of 1934 (1934 Act). In addition to the 1934 Act that created it, the Commission enforces the Securities Act of 1933, the Trust Indenture Act of 1939, the Investment Advisors Act of 1940, the Investment Company Act of 1940, and the Sarbanes-Oxley Act of 2002. The Commission is comprised of five Commissioners, one of which includes the Chairman, who are appointed by the U.S. President, and approved by the Senate. The statutes administered by the Commission are designed to promote full public disclosure, and to protect the investing public against fraudulent and manipulative practices in the securities market.

The Division of Enforcement (Enforcement) was created in August 1972, to consolidate enforcement activities that previously had been handled by the various operating divisions at the Commission's headquarters in Washington, D.C. The Commission's enforcement staff<sup>5</sup> conducts investigations into possible violations of the federal securities laws, and prosecutes the Commission's civil suits in the federal courts, as well as its administrative proceedings.

In civil suits, the Commission seeks injunctions, which are orders that prohibit future violations. A person who violates an injunction is subject to fines or imprisonment for contempt. In addition, the Commission often seeks civil monetary penalties and the disgorgement of illegal profits, or losses avoided. The courts may also bar or suspend defendants from acting as corporate officers or directors.

The Commission can bring a variety of administrative proceedings, which are heard by administrative law judges and the Commission itself, if appealed. Proceedings for a cease and desist order may be instituted against any person who violates the federal securities laws. The Commission may order the respondent to disgorge ill-gotten funds in these proceedings. With respect to regulated entities (e.g., brokers, dealers and investment advisers) and their employees, the Commission may institute administrative proceedings to

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<sup>5</sup> For purpose of this report, "Enforcement staff" includes those staff in the Commission's Regional Offices.

revoke or suspend registration, or to impose bars or suspensions from employment. In proceedings against regulated persons, the Commission is authorized to order the payment of civil penalties, as well as disgorgement.

The Commission's Division of Enforcement is responsible for reviewing disgorgement waiver requests. Disgorgements represent ill-gotten gains, or losses avoided, resulting from individuals or entities violating the federal securities laws. The Commission seeks disgorgements in order to ensure that securities law violators do not profit from their illegal activities. When appropriate, the disgorged funds are returned to injured investors. Penalties are also levied on violators of federal securities laws as appropriate. Disgorgements and penalties may be ordered in either administrative proceedings or civil actions, and the cases may be settled or litigated.

Enforcement can recommend to the Commission that disgorgements be completely or partially waived, based on the defendant/respondent's demonstrated inability to pay, among other policy reasons. In reviewing a waiver request, the enforcement procedures require the staff to request sworn financial statements. *See* *Recommending Financial Waivers and Payment Plans to the Commission* revised as of January 14, 2005 (hereinafter, referred to as "Enforcement's policies and procedures governing the disgorgement waiver process.") The defendants/respondents are required to attach copies of the following documents to the sworn financial statements submitted:

- Federal income and gift tax returns, including schedules and attachments associated with them;
- Bank account statements;
- Credit card and brokerage account statements, insurance policies, mortgage documentation;
- Any financial statement prepared by the defendant/respondent, including bankruptcy schedules; and
- Documents evidencing current loans.

Additionally, Enforcement's staff are required to conduct a credit check on the defendants/respondents, and perform Internet or Lexis/Nexis searches on the defendants/respondents, as well as their relatives and friends in certain instances. These searches are to corroborate the defendants/respondents' stated financial condition and to identify hidden assets, overstated liabilities, unreported income, and overstated expenses. The financial statements provided by the defendants/respondents show their assets, liabilities, income

and expenses. In cases where the Commission waives the disgorgements, penalties are not assessed against the defendants/respondents.

In Fiscal Year (FY) 2006, the Commission initiated 914 investigations, 218 civil proceedings, and 356 administrative proceedings.<sup>6</sup> These proceedings covered a wide range of issues. Major areas of enforcement activity were: corporate financial fraud, including abusive backdating of stock options; compliance failures at self-regulated organizations and broker-dealers; and fraud related to mutual funds. The Commission's enforcement cases resulted in a total of more than \$3.3 billion in disgorgements and penalties ordered against securities law violators during FY 2006. Whenever practical, the Commission sought to return funds to harmed investors, through the use of the "fair fund" provision of the Sarbanes-Oxley Act.<sup>7</sup>

For FY 2006, FY 2007, and the time period from October 1, 2007 through May 31, 2008, the Commission granted waivers in the amounts of \$73.5 million, \$67.8 million, and \$37.1 million, respectively.<sup>8</sup>

Based on the OIG's prior findings involving the disgorgement waiver process mentioned above, the OIG contracted Regis & Associates, PC to conduct a review of Enforcement's disgorgement waiver process.

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<sup>6</sup> GAO-07-134 Financial Audit, Securities and Exchange Commission's Financial Statements for Fiscal Years 2006 and 2005.

<sup>7</sup> Section 308 of the Sarbanes Oxley Act of 2002, 15 U.S.C. § 7246.

<sup>8</sup> Source: The Phoenix computer system which is maintained by the Division of Enforcement.

# Objectives, Scope and Methodology

## Objectives

Our review objectives were to: (a) evaluate Enforcement's disgorgement waiver process' compliance with governing policies and procedures and identify possible improvements, (b) determine whether defendants/respondents misrepresented their financial position to Enforcement in seeking disgorgement waivers, (c) quantify the defendants/respondents' actual amount of undisclosed assets, overstated liabilities, underreported income and overstated expenses, versus the stated amounts, and (d) follow up on prior OIG recommendations.

## Scope and Methodology

Regis & Associates, PC, was requested by the Securities and Exchange Commission – Office of Inspector General (OIG) to provide professional services in conducting a review of the Division of Enforcement's disgorgement waivers. The scope of the professional services was limited to a review of the investigative case files for each defendant/respondent included in a sample that was judgmentally selected by Regis & Associates, PC in consultation with the OIG. Regis & Associates, PC reviewed 63 investigations, which represented 72 individual defendants/respondents and entities who received either a full or partial disgorgement waiver. Our audit fieldwork was performed from July 7 through August 29, 2008, using procedures approved by the OIG. The review methodology is detailed below.

Our methodology was designed by utilizing a risk-based approach. The review consisted of several processes including: reviewing policies and procedures governing the disgorgement waiver process; conducting interviews and walk-through procedures with appropriate Enforcement personnel to document our understanding and observe the actual processes in-place; identifying high risk areas; and, detailed testing of selected disgorgement waiver case files. We performed research and also consulted with the staff at the Commodities and Futures Trading Commission to identify possible best practices in the disgorgement waiver process.

We held a planning meeting and conducted an entrance conference with officials from the OIG and Enforcement. We also obtained and reviewed Enforcement's policies and procedures governing the disgorgement waiver process. Based on our preliminary discussions with officials of the Commission, we identified potential risk areas regarding the disgorgement waiver process. These included:

- Inadequate policies or processes for reviewing sworn financial statements and other documentation submitted by the defendants/respondents during the waiver process (e.g., Enforcement had not adopted a comprehensive procedure for finding hidden assets, revenues, etc.);
- Inadequate guidance for the review of disgorgement waiver case files;
- Lack of comprehensive training for staff involved in the disgorgement waiver process;
- The possibility that Enforcement staff could have conducted substandard work when reviewing a waiver, in light of incentives to close out investigations in a swift and timely fashion;
- Insufficient documentation supporting disgorgement waiver recommendations granted to defendants/respondents; and
- The inability of Enforcement staff to identify or find hidden assets/revenues, and overstated liabilities/expenses of defendants/respondents.

### **Sample Size Selection**

Enforcement provided the OIG with a list (from Enforcement's Phoenix system) of approved disgorgement waivers that were granted during fiscal years (FY) 2006, 2007, and the time period between October 2007 and May 2008, based on the defendants/respondents' inability to pay, among other policy reasons. The OIG requested that we review approximately 30 percent of the waiver cases in both FY 2006 and 2007, and 100 percent of the waiver cases in FY 2008 (as of May 31, 2008). This resulted in a total of 63 investigations, which involved 72 defendants/respondents. The table below shows the number and amount of disgorgement waivers granted by Enforcement during FY 2006; 2007; and October 1, 2007 to May 2008, based on the defendants/respondents' inability to pay, among other policy reasons, and the resulting sample size for each of the three years under review.

**Table 1. Sample Size for FYs 2006 – 2008**

<b>Fiscal Year</b>	<b>Total Amount Waived</b>	<b>Approved Waiver Cases</b>	<b>Sample Percentage</b>	<b>Sample Size Reviewed</b>	<b>Sample Size Amount</b>	<b>Sample Size Percentage</b>
2006	\$ 72,647,699.20	62	30%	18	\$ 58,132,302.70	80%
2007	\$ 67,814,563.84	61	30%	18	\$ 27,795,120.83	41%
2008 <sup>9</sup>	\$ 37,143,257.99	27	100%	27	\$ 37,143,257.99	100%
<b>Total</b>	<b>\$ 177,605,521.03</b>	<b>150</b>		<b>63</b>	<b>\$ 123,070,681.52</b>	

Source: Generated by Regis & Associates, PC, based on information provided by Enforcement.

The 63 selected files represented disgorgement waivers, totaling \$123,070,681.52, which is approximately 70% of the \$177,605,521.03 in total waivers granted, based on inability to pay, among other policy reasons, for the period of FY 2006 through May 31, 2008. The case selection for FYs 2006 and 2007 was based on a combination of high-dollar value disgorgement waiver cases and judgmental samples. The case selection also took into account the type of case (e.g., insider trading, market manipulation, etc.).

Enforcement provided us with a population of 153 cases of disgorgement waivers, totaling \$178,614,289. Based on our review of the applicable Action Memoranda detailing Enforcement’s recommendation to the Commission, we determined that waivers had actually not been granted for three of those cases. We, accordingly, eliminated those three cases from the population. This resulted in a new population of 150 cases, totaling \$177,605,521.03 in actual waivers, granted for the period under review. Based on our discussions with the OIG, we further eliminated 14 investigations from the population because the investigations in question were particularly sensitive.<sup>10</sup> This resulted in a new waiver case population of 136, totaling \$176,406,074.49. The final population for the sample is shown below in Table 2.

<sup>9</sup> For the period October 1, 2007 to May 31, 2008.

<sup>10</sup> These 14 investigations were described as involving very unique circumstances, e.g., confidential informants, that were unrelated to the waivers, and that did not lend itself to this type of expedited review.

**Table 2 Final Population**

	<b>Number of Accounts</b>	<b>Amount Waived</b>
<b>FY 2006</b>	49	\$ 71,771,321.69
<b>FY 2007</b>	60	\$ 67,491,494.81
<b>FY 2008</b>	27	\$ 37,143,257.99
<b>Total</b>	136	\$ 176,406,074.49

Source: Generated by Regis & Associates, PC, based on information provided by Enforcement.

For the 63 case files identified in Table 1, we reviewed the related documentation to determine whether the recommendations for the waivers were based on well-informed decisions. We also reviewed the case files to determine whether the required documentation such as the SFS, the Checklists for Reviewing Sworn Financial Statements (the Checklists), and the defendants/respondents' income tax returns, credit reports, bank and brokerage statements and bankruptcy schedules (where appropriate) were obtained and reviewed by Enforcement staff. We reviewed the SFS to ensure that they were signed by the defendants/respondents and notarized. We reviewed the checklists for completeness and for evidence of supervisory review. We compared the amounts reported on the defendants/respondents' SFS to the related supporting documentation, such as bank and brokerage statements, bills, settlement sheets for real estate transfers, tax returns, and loan documents. We reviewed the defendants/respondents' tax returns to ascertain any income or indications of assets reported to the IRS, which may not have been reported on the SFS. We reviewed bank and credit card statements for large transfers from the defendants/respondents' accounts, which may indicate income, purchases, or dispositions of assets, which may not have been reported on the SFS. We reviewed the defendants/respondents' credit reports for indications that the defendants/respondents may have overstated their liabilities and expenses, and to determine their credit standing.

#### **Use of Computer Processed Data**

We used computer-processed disgorgement waiver data maintained in Enforcement's Phoenix System, which was provided to the OIG. We verified the arithmetical accuracy of the computations. We did not test the internal controls over the Phoenix System to determine data integrity and reliability. We also used the following public databases to search for, to the extent possible, financial information relating to the selected

defendants/respondents: Choicepoint/Autotrack, Lexis/Nexis, and Westlaw. The constraints involved in utilizing the various public databases included restrictions imposed by State laws and regulatory institutions on the nature and type of financial information about individuals that was allowed on public search databases.

### **Prior Audit Coverage**

We followed up on recommendations noted in the OIG Audit Reports 311<sup>11</sup> and 384<sup>12</sup> to determine the corrective measures implemented by Enforcement in the disgorgement waiver review process.

We conducted this review in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the review to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our review objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our review objectives.

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<sup>11</sup> Audit Report 311 (Title: Disgorgements) dated January 11, 2001.

<sup>12</sup> Audit Report 384 (Title: Enforcement Disgorgement Waivers) dated January 18, 2005.

## FINDINGS AND RECOMMENDATIONS

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### **Finding 1: Defendants/Respondents Appear to Have the Ability to Pay at Least Some Portion of the Disgorgements Waived**

Individuals or entities that violate federal securities laws may be required to pay disgorgements and/or penalties. If the individuals or entities assert they do not have the ability to pay, they may request a waiver of the amount owed. These individuals or entities are required to submit SFS detailing their financial condition. Upon receipt, Enforcement staff attorneys review the SFS to determine whether they are indeed unable to pay the stated disgorgement amount and/or penalties (as appropriate). Our review of 72 disgorgement waivers identified three instances where the defendants/respondents appeared to have some ability to pay at least some portion of the disgorgement amounts waived. Specifically, we determined that these defendants/respondents had substantial assets, good credit scores, positive net worth, and positive monthly net income, yet requested and obtained full disgorgement waivers. Table 3 identifies the three cases in which the defendants/respondents appeared to have some ability to pay at least a portion of the disgorgement.

**Table 3. Defendants/Respondents with Ability to Pay.**

Reference Number	Total Amount Waived
DFD-3(a)	320,000.00
DFD-3(b)	320,000.00
DFD-40	521,580.00
<b>Total</b>	<b>\$841,580.00<sup>13</sup></b>

Source: Generated by Regis & Associates, PC,  
based on information provided by Enforcement.

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<sup>13</sup> Reference number DFD-3 involves two defendants/respondents who were jointly and severally liable for the disgorgement amount of \$320,000, which was waived, and therefore, this amount was counted once in the computation of the total amount waived.

The specific factors involved in each case are described below:

For reference number DFD-3(a), we noted that the individual had a positive monthly net income of \$4,717.54 and a positive net worth of \$12,410. During our review of the action memorandum, Enforcement's staff attorneys stated, "It is noteworthy that the individual has no prior disciplinary or criminal history, and that he was cooperative throughout the litigation and expressed remorse to the staff for his wrongdoing." While we acknowledge that Enforcement is entitled to use subjective considerations such as criminal history and the level of cooperation of the individual in the recommendation for the waiver, based on the individual's net income and net worth, we determined that Enforcement should have considered the possibility of arranging a payment plan for the individual to pay at least some portion of the disgorgement amount waived.

For reference number DFD-3(b), we noted that the individual had a positive net worth of \$481,139.97 and good credit scores of 776, 781, and 797.<sup>14</sup> The individual's net worth included notes receivable totaling \$373,704. However, in the analysis of the individual's financial condition with regard to his ability to pay the disgorgement, Enforcement excluded the notes receivable of \$373,704 on the basis that these notes were uncollectible in the near future. We were unable to obtain adequate supporting documentation such as the audited financial statements of the debtor entities in question to support the assertion that they were insolvent, thus, rendering the notes receivable uncollectible.

In recommending the waiver, Enforcement's action memorandum stated that the individual had no prior disciplinary or criminal history, was cooperative throughout the litigation, and expressed remorse for his wrongdoing. While we note that Enforcement is entitled to use subjective considerations such as criminal history and the level of cooperation of the individual, in the recommendation for the waiver, based on the individual's positive net worth and good credit scores, we determined that Enforcement should have considered the possibility of arranging a payment plan for the individual to pay at least some portion of the disgorgement amount waived.

For reference number DFD-40, we noted that the individual had a positive net worth of \$18,115 and good credit scores of 697, 709, and 715. In recommending the waiver, the Enforcement stated in the action

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<sup>14</sup> A good credit score generally indicates that the defendant/respondent is meeting his or her current financial obligations in a timely manner. Enforcement stated that they never directed the staff to base their waiver recommendation on credit scores. However, we believe that a good credit score is one of the factors that indicate that the defendant/respondent may be in a position to pay at least some of the disgorgement.

memorandum that the individual had no resources to pay the disgorgement amount, and that he had agreed to act as a witness against other individuals in another litigation. However, Enforcement's procedures do not specifically allow waivers to be based upon a consideration that the defendant/respondent agreed to act as a witness in litigation. Moreover, based on the positive net worth and good credit scores identified above, we determined that Enforcement should have considered the possibility of arranging a payment plan for the defendant/respondent to pay at least some portion of the disgorgement amount waived.

The audit found that in the above-referenced cases, Enforcement should have considered arranging payment plans so that some portion of the ill-gotten gains (or losses avoided) could be recaptured by the Government and provided to injured investors, as appropriate.

Pursuant to *Enforcement's Recommending Financial Waivers and Payment Plans to the Commission* (page 12), partial waivers may be combined with payment plans. These procedures specifically contemplate situations where a defendant/respondent's net worth and/or potential income is insufficient to satisfy the entire disgorgement order and recommends that partial payments be made, even if the payment "barely makes an impact on the full amount of defendants' ill-gotten gain."

**Recommendation 1:**

Enforcement should undertake appropriate actions to ensure that staff comply with its procedures and consider payment plans and partial waivers in situations where defendants/respondents have the ability to pay some portion of the disgorgement amount.

**Finding 2: Assets Stated on the SFS Were Found to be Inaccurate**

Enforcement's procedures (page 3) require staff attorneys to review defendants/respondents' SFS to reasonably ensure that the information they provided is an accurate assessment of their financial condition. The staff attorneys are required to obtain documentation to support the defendants/respondents' assets, liabilities, and income.<sup>15</sup> The staff attorneys are also required to perform public database searches on the

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<sup>15</sup>This was noted in Enforcement's policies and procedures governing the disgorgement waiver process (at pages 4 and 5).

defendants/respondents to corroborate their assets, liabilities, and stated income. We identified two instances where the assets were not accurately stated on the SFS. Specifically, we were unable to reconcile the amounts reported on the SFS to the supporting documentation and public database searches.

Assets totaling at least \$386,237.78 for two defendants/respondents were underreported. Table 4 identifies the two cases in which assets were underreported on the SFS.

**Table 4. Assets Underreported**

Reference Numbers	Amount Waived	Assets Under Reported
DFD-46	231,633.00	12,533.78
DFD-3(b)	320,000.00	373,704.00
<b>TOTAL</b>	<b>\$944,018.39</b>	<b>\$386,237.78</b>

Source: Generated by Regis & Associates, PC, based on information provided by Enforcement.

The specific factors involved in each case are described below:

For reference number DFD-46, we noted that the funds identified on the individual’s bank statement were not included in the individual’s final SFS. Specifically, the individual’s bank statement identified funds in the amount of \$12,533.78; however, these funds were not reported on the individual’s SFS. This indicates that the subject individual’s financial status was not accurately reported on the SFS.

For reference number DFD-3(b), we noted that Enforcement indicated in the action memorandum that notes receivable for the individual in the amount of \$373,704 were considered to be uncollectible, based on the fact that the debtor entities were insolvent, illiquid, and unassignable. However, the notes receivable were included as an asset in the individual’s SFS. We were unable to obtain adequate supporting documentation such as the audited financial statements of the debtor entities in question to support the assertion that they were insolvent, thus, rendering the notes receivable uncollectible.

Pursuant to the procedures (page 2), “the staff must take special care to make sure that it has as much information as it can reasonably obtain about the defendant’s financial condition ...and that it has carefully considered whether

a waiver is appropriate.” Additionally, “the staff must analyze the SFS to obtain reasonable assurance that it is accurate.”

We concluded that in the above-identified cases, due to the absence of adequate supporting documentation, the defendant/respondent’s assets were underreported. As a result, the subject defendants/respondents’ disgorgement waiver requests were granted based on the inaccurate financial information of the defendants/respondents.

**Recommendation 2:**

Enforcement should undertake appropriate actions to ensure that it reviews the defendants/respondents’ financial information for accuracy prior to recommending a disgorgement waiver.

**Finding 3: Adequate Supporting Documentation for Assets, Liabilities, Income, and Expenses of all Defendants/Respondents Should be Obtained and Retained**

During the disgorgement waiver investigation process, defendants/respondents submit supporting documentation for assets, liabilities, income, and expenses reported on the SFS. The supporting documentation includes bank statements, credit reports, asset titles, vendor statements, pay stubs, and receipts. The staff attorneys then review the documentation to corroborate the financial assertions stated on the SFS. We noted several instances where adequate supporting documentation was not provided for the assertions on the SFS.

Pursuant to the procedures, the Enforcement staff “must assess how the specific items on the SFS affect the defendant’s ability to pay and our practical and legal ability to collect on a monetary judgment.”<sup>16</sup> This necessitates the review of adequate supporting documentation to corroborate the amounts stated on the SFS. Furthermore, the procedures direct Enforcement Staff to obtain information such as bank statements, credit card statements, brokerage account statements, insurance policies, and mortgage documentation, where appropriate, to support the defendant/respondent’s financial assertions.

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<sup>16</sup> This was noted in Enforcement’s policies and procedures governing the disgorgement waiver process (at page 7).

Our audit found that adequate supporting documentation for assets, liabilities, income and expenses of all defendants/respondents was not always retained, and some waivers were granted based on unsubstantiated amounts reported on the defendants/respondents' SFS. The OIG's Audit Report 384, dated January 18, 2005 also revealed similar internal control weaknesses.

### **Assets not Supported by Adequate Documentation**

The assets reported on the SFS for seven of the 72 defendants/respondents we reviewed were not supported by documentation such as bank statements and asset titles. These reported assets included cash, real estate, automobiles, and notes receivable. As a result of the unavailability of adequate supporting documentation, we were unable to determine the validity of assets reported by the defendant/respondent and thus, it is possible that the defendants/respondents underreported certain assets. Table 5 identifies the seven cases in which assets on the SFS were not supported by adequate documentation.

**Table 5. Assets not Supported by Adequate Documentation**

<b>Reference Numbers</b>	<b>Amount Waived</b>	<b>Amount Unsupported</b>
DFD-13	284,385.82	14,900.00
DFD-32(b)	9,941,200.00	3,303,000.00
DFD-42	392,385.39	419,049.00
DFD-27	1,057,542.63	23,315.00
DFD-52	31,266.75	23,595.00
DFD-23	645,945.00	57,860.96
DFD-15	181,822.00	143,780.00
<b>TOTAL</b>	<b>\$12,534,547.59</b>	<b>\$3,985,499.96</b>

Source: Generated by Regis & Associates, PC, based on information provided by Enforcement.

The specific factors involved in some of the cases are described below:

For reference number DFD-13, we noted that the action memorandum identified a vacant lot, valued at \$14,900 in the name of individual. This property was not reported in the individual's SFS. In the action memorandum, Enforcement indicated that it excluded the value of the lot in the computation of the individual's net worth because the individual claimed that the lot was sold to a partner and that since the individual's net worth was negative, its waiver analysis would not have changed anyway. However, Enforcement decided to rely solely on the claim by the individual and did not pursue the matter to determine true ownership of the property.

For reference number DFD-32(b), we were unable to locate documentation supporting the assets reported by the individual on the SFS. Enforcement indicated that this documentation was in the possession of another federal entity and that due to the voluminous nature of the records, copies of the supporting documentation were not made.

For reference number DFD-42, the individual's SFS identified assets totaling \$419,049.00; however, no supporting documentation such as bank statements was provided to support the SFS assertions.

For reference number DFD-27, the individual had several vehicles, only one of which was included on the SFS. We specifically identified three vehicles that were not reported on the individual's SFS. These three vehicles, which were registered in the names of either the individual or his spouse, were identified through public database searches on the individual. Enforcement stated that one of the vehicles was actually a leased vehicle belonging to the individual's spouse. Enforcement stated that the second vehicle was not reported because the vehicle in question was a 1984 Nissan that has virtually no resale value, and thus, was excluded in the analysis of the individual's financial condition. Enforcement stated that the third vehicle actually belonged to the individual's son, who shared the same name with the individual.

Enforcement maintained that it did not further investigate the claim that the son owned the vehicle because of its nominal value, although it did make inquiries to confirm the son's name and that he lived at the same address where the vehicle was registered. However, Enforcement failed to explain in the action memorandum as to why the vehicle in question was not reported by the individual on the SFS. Furthermore, we were unable to obtain evidence to support the fact that the third vehicle noted above, belonged to the son of the individual. In addition, we were unable to obtain documentation to confirm that one of the vehicles noted above was actually a leased vehicle.

For reference number DFD-52, the individual's SFS identified assets in the amount of \$23,595, however, no supporting documentation was provided to support the SFS' assertion.

For reference number DFD-23, the individual's SFS identified bank and brokerage account balances totaling \$57,860.96, however, no supporting documentation such as bank statements was provided to support the SFS' assertions. Enforcement stated that prior to the individual's settlement offer, he transferred the bulk of his funds (\$45,000) to his attorney's trust account

to pay the disgorgement, and that they discussed the individual's financial condition with the Court-Appointed Receiver. However, no documentation was found in the file to support these contentions.

For reference number DFD-15, the individual's SFS identified assets in the amount of \$143,780, however, no supporting documentation was provided to support the SFS assertion.

### **Liabilities not Supported by Adequate Documentation**

The liabilities reported on the SFS for 21 of 72 defendants/respondents were not supported by any documentation such as mortgage and credit card statements. These reported liabilities included mortgages, loans, and credit card debt. As a result of unsupported liabilities, it is possible that the liabilities do not exist or are inflated. Table 6 identifies the 21 cases in which liabilities were not supported by documentation.

**Table 6. Liabilities not Supported by Documentation**

<b>Reference Numbers</b>	<b>Amount Waived</b>	<b>Unsupported Liabilities</b>
DFD-2	\$ 881,000.00	\$ 200,000.00
DFD-21	1,716,590.00	85,000.00
DFD-44	351,537.13	18,275.00
DFD-20	2,564,987.00	11,931.38
DFD-36	1,573,825.24	186,079.00
DFD-13	284,385.82	8,000.00
DFD-32(a)	9,941,200.00	213,221.08
DFD-32(b)	9,941,200.00	810,515.00
DFD-52	31,266.75	71,721.00
DFD-46	231,633.00	3,500.00
DFD-53	18,308.00	6,663.00
DFD-3(b)	320,000.00	579,753.00
DFD-40	521,580.00	31,340.00
DFD-50	115,000.00	10,051.00
DFD-41	447,600.00	16,705.00
DFD-38	906,326.65	14,000.00
DFD-16	69,004.00	468,083.00
DFD-33(a)	5,233,746.00	8,044.00
DFD-30	640,704.00	14,473.00
DFD-15	181,822.00	143,757.00
DFD-24	223,665.32	5,500.00
<b>TOTAL</b>	<b>\$26,254,180.91</b> <sup>17</sup>	<b>\$2,906,611.46</b>

Source: Generated by Regis & Associates, PC, based on information provided by Enforcement.

<sup>17</sup> Reference number DFD-32 involves two defendants/respondents who received a combined waiver amount of \$9,941,200.00; therefore, this amount was counted once in the computation of the total amount.

The specific factors involved in these cases are described below:

For reference number DFD-2, Enforcement indicated in the action memorandum that the tax liability in the amount of \$200,000 reported on the individual's SFS was an estimate because the tax returns were never filed, and that they relied on this assertion when computing the individual's net worth.<sup>18</sup> However, as a result of our inability to obtain the needed supporting documentation, we were unable to determine the validity of the tax liability reported by the individual.

For reference number, DFD-21, the individual reported liabilities totaling \$85,000 that were unsupported. Of that amount, \$65,000 was an estimated tax liability while the other \$20,000 was for attorney fees. Enforcement verified the individual's non-filing status with IRS, however, documentation to support the amount of the individual's estimated tax liability was not provided. Also, we were unable to obtain supporting documentation such as invoices to support the attorney fees reported by the individual on the SFS. It is worth noting that Enforcement stated that given the individual's high negative net worth, the validity of these unsupported liabilities may not have changed the partial waiver recommendation since they had already collected every available asset.

For reference number DFD-44, the SFS identified auto loans in the amount of \$18,275. However, no supporting documentation was provided. Enforcement agreed; although noted that given the individual's negative net worth, the auto loans may not have impacted the waiver recommendation.

For reference number DFD-20, the SFS identified a liability for Canadian property management fees in the amount of \$11,931.38. Enforcement stated that they provided documentation for this liability, totaling \$11,931.38; however, we could not find any supporting documentation for the liability in the individual's case file. Enforcement did not believe that its failure to obtain documentation for this liability affected their assessment of the individual's financial condition given his significant documented liabilities.

For reference number DFD-36, we noted a discrepancy between the amount of an auto loan listed on the individual's SFS and the individual's credit report. The individual's SFS identified an auto loan in the amount of \$45,000; however, only \$25,275 of the total amount of the auto loan was supported by documentation. This resulted in a difference of \$19,725 that was not supported by documentation. We further noted another discrepancy

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<sup>18</sup> Enforcement's procedures (at page 13) require the staff to confirm with the IRS that the returns were never filed. We have no evidence to indicate that the staff confirmed this information.

between the credit card debt listed on the individual's SFS and the individual's credit report. Specifically, the individual's SFS identified credit card debt in the amount of \$222,773; however, only \$59,857 of the total credit card debt was supported by documentation. This resulted in a difference of \$162,916 that was not supported by documentation. The individual's SFS also identified accrued real estate taxes in the amount of \$3,438 that were not supported by documentation. We noted that the total amount of auto loan, credit card debts, and accrued real estate taxes not supported by documentation was \$186,079. According to Enforcement, the unsupported liabilities in question were mostly the liabilities of the individual's spouse. Enforcement indicated that they were, therefore, unable to obtain the credit report of the individual's spouse since she was not part of the investigation. We noted, however, that even though Enforcement claimed that most of the unsupported liabilities in question belonged to the spouse of the individual, the total amount of the liabilities was included in the computation of the individual's net worth as instructed by the SFS. Enforcement stated that the individual's spouse's liabilities were included in the individual's SFS because the state in which they reside is a community property state. We further noted that the liabilities of the individual and his spouse were not stated separately on the SFS; therefore, we were unable to determine whether the unsupported liabilities actually belonged to the spouse.

For reference number DFD-13, Enforcement stated that the individual provided supporting documentation for the accrued real estate taxes totaling \$8,000 that were reported on the SFS. However, Enforcement stated that they were unable to provide the supporting documentation because it was in the custody of a retired staff member and accordingly, consider the supporting documentation in question to be missing.

For reference number DFD-32(a), the SFS identified credit card debt in the amount of \$326,400. However, supporting documentation was provided for only \$192,178.92 of that amount, leaving a remaining balance of \$134,221.08 that was not supported by documentation. The SFS also identified auto loans in the amount of \$29,000, an insurance loan in the amount of \$20,000, and another loan in the amount of \$30,000. However, no supporting documentation was provided.

For reference number DFD-32(b), the SFS identified a mortgage in the amount of \$2,224,000. However, supporting documentation was provided for only \$1,588,485, leaving \$635,515 unsupported. The SFS also identified other loans and notes payable of \$130,000, accrued real estate taxes of \$35,000, and accrued income taxes of \$10,000. Enforcement stated that documentation supporting the individual's assets were currently in the

possession of another federal entity. Also, Enforcement stated that due to the voluminous nature of the records, copies of the supporting documentation were not made.

For reference number DFD-52, the SFS identified auto loans of \$3,069, credit card debt of \$15,152, other loans or notes payable of \$4,000, judgments/settlements of \$500, taxes of \$34,000, and legal fees of \$15,000. However, no supporting documentation was provided.

For reference number DFD-46, the SFS identified credit card debt in the amount of \$3,500. However, no supporting documentation was provided.

For reference number DFD-53, we determined that documentation provided to support the credit card debt amounted to \$3,727 of the total reported debt of \$10,390. This resulted in a difference of \$6,663 that was not supported by documentation. We noted that Enforcement provided partial documentation to support the credit card debt; however, the full amount of credit card debt reported on the individual's SFS was considered in the computation of the individual's net worth.

For reference number DFD-3(b), the SFS identified credit card debt in the amount of \$181,617 and a mortgage in the amount of \$398,136. However, no supporting documentation was provided.

For reference number DFD-40, the SFS identified credit card debt in the amount of \$31,340. However, no supporting documentation was provided.

For reference number, DFD-50, the SFS identified auto loans in the amount of \$44,730; however, supporting documentation was provided for only \$34,679 of that amount. This resulted in a difference of \$10,051 that was not supported by documentation. In the absence of adequate supporting documentation, we were unable to determine the validity of the auto loan reported by the individual.

For reference number DFD-41, the SFS identified credit card debt in the amount of \$25,370; however, supporting documentation was provided for only \$15,515. This resulted in a difference of \$9,855 that was not supported by documentation. Also, no supporting documentation was provided for medical bills in the amount of \$6,850.

For reference number DFD-38, the SFS identified notes payable in the amount of \$14,000. However, no supporting documentation was provided. Enforcement maintained that the lack of documentation was not relevant

because the staff verified and obtained all of the individual's assets (except for retirement funds and the like).

For reference number, DFD-16, we noted that liabilities totaling \$468,083 were not supported by adequate documentation. The unsupported liabilities consisted of legal fees of \$443,000, credit card debt of \$24,083, and an installment loan of \$1,000 from the individual's mother. Enforcement stated that the Commission was notified that the \$1,000 loan was disregarded due to a lack of adequate supporting documentation for the loan. However, we noted that the individual's SFS presented in the action memorandum included this loan in the computation of the individual's net worth. Enforcement stated that this was a partial waiver case where the individual had a negative net worth. The payment plan was based on the individual's income and an assumption that the individual had a net worth of zero.

For reference number, DFD-33(a), the individual reported auto loans totaling \$56,772 on the SFS. However, the individual's credit report indicated auto loans in the amount of \$48,728. This resulted in a difference of \$8,044 that was not supported by documentation.

For reference number DFD-30, the SFS identified credit card debt in the amount of \$12,673 and real estate taxes in the amount of \$1,800. However, no supporting documentation was provided. According to Enforcement, the documents relating to these liabilities have been misplaced as a result of the trial counsel's files being relocated several times during office moves.

For reference number DFD-15, the SFS identified credit card debt in the amount of \$74,783; however, supporting documentation was provided for only \$16,960. This resulted in a difference of \$57,823 that was not supported by documentation. Also, no supporting documentation was provided for installment loans in the amount of \$899, loans to a third party in the amount of \$10,200, a debt to the IRS in the amount of \$70,000 and a liability of \$4,835 for the "Operation of a Business."

For reference number DFD-24, the SFS identified legal fees in the amount of \$4,500 and medical fees in the amount of \$1,000. However, no supporting documentation was provided. Enforcement stated that they based their assessment on the staff attorney's personal knowledge (e.g., a pretrial conference) of the case.

### **Monthly Income not Supported by Adequate Documentation**

In addition, the monthly income reported on the SFS for five of 72 defendants/respondents was not supported by any documentation such as pay

stubs. The reported monthly income included salaries, wages, and commissions and fees. Unsupported income could be problematic because of the possibility that a defendant/respondent underreports his/her income. Table 7 below identifies the five cases in which monthly income was not supported by documentation.

**Table 7. Monthly Income not Supported by Documentation (Annualized)**

Reference Numbers	Amount Waived	Annualized Unsupported Income
DFD-2	881,000.00	10,655.94
DFD-37	1,391,715.83	30,000.00
DFD-47	196,367.00	120,000.00
DFD-52	31,266.75	197,892.00
DFD-15	181,822.00	83,004.00
<b>TOTAL</b>	<b>\$2,682,171.58</b>	<b>\$441,551.94</b>

Source: Generated by Regis & Associates, PC, based on information provided by Enforcement.

The specific factors involved in these cases are described below:

For reference number DFD-2, we noted that the individual’s bank statement identified four deposits totaling \$10,655.94 that were not reported on the SFS. Enforcement was unable to provide us with several months of bank statements to enable us to determine whether the deposits noted above were non-recurring transactions. Subsequent to our detection of the deposits in question, Enforcement stated that they contacted the bank and the bank confirmed that the deposits were one-time transactions. In the absence of three or more months of bank statements, we were unable to independently confirm the nature and frequency of those unreported deposit transactions.

For reference number DFD-37, the SFS identified consulting fees of \$2,500 per month. This income, for which no supporting documentation was provided (although, Enforcement stated that documentation had been provided), totaled \$30,000 when annualized.

For reference number DFD-47, the SFS identified salaries/wages of \$10,000 per month. No supporting documentation was provided for these salaries/wages which, when annualized, totaled \$120,000.

For reference number DFD-52, the SFS identified Spot Forex commissions of \$15,000 per month, debit card machine receipts of \$320 per month, and

Social Security income of \$1,171 per month. This income, for which no supporting documentation was provided, totaled \$16,491, and when annualized, \$197,892.

For reference number DFD-15, the SFS identified salaries/wages of \$1,353 per month, and commissions/advances in the amount of \$5,564 per month. This income, for which no supporting documentation was provided, totaled \$6,917, and when annualized, \$83,004. Enforcement stated that some documentation was provided while other documentation was reviewed by the staff during the waiver process but was not retained.

### **Monthly Expenses not Supported by Adequate Documentation**

The monthly expenses reported on the SFS for 23 of the 72 defendants/respondents were not supported by any documentation, such as vendor statements and receipts. The reported monthly expenses included mortgage, rent, utilities, insurance, and food. In the absence of adequate supporting documentation, we were unable to determine the validity of the monthly expenses reported by the defendants/respondents. If expenses are unsupported, it is possible that they are non-existent or inflated. Enforcement stated that most of the expenses seemed reasonable to them, and therefore, they did not request or require supporting documentation. However, Enforcement's procedures do not clearly define the parameters for reasonable expenses that do not require the submission of supporting documentation. We classified the 23 instances of monthly expenses not being adequately supported as involving either large or small monthly expense.

#### Large Monthly Expenses

As indicated in Table 8(a), we found nine instances where, in our opinion, either the total amount claimed or an individual expense was large enough that it should have been verified. In these instances, the documentation could have included leases, mortgage statements, canceled checks, insurance bills/statements, attorney bills/statements, etc.

**Table 8(a). Large Monthly Expenses not Supported by Documentation (Annualized)**

Reference Numbers	Amount Waived	Annualized Unsupported Expenses
DFD-53	\$ 18,308.00	\$ 53,448.00
DFD-11	398,288.00	181,776.00
DFD-32(b)	9,941,200.00	231,000.00
DFD-47	196,367.00	78,000.00
DFD-52	31,266.75	211,272.00
DFD-30	640,704.00	54,564.00
DFD-39	553,557.11	124,993.56
DFD-43	377,379.00	123,600.00
DFD-15	181,822.00	95,952.00
<b>Total</b>	<b>\$12,338,891.86</b>	<b>\$1,154,605.56</b>

Source: Generated by Regis & Associates, PC, based on information provided by Enforcement.

The specific factors involved in these cases are described below:

For reference number DFD-53, the SFS identified legal fees in the amount of \$1,000 per month, mortgage payments in the amount of \$660 per month, credit card payments in the amount of \$600 per month, and miscellaneous expenses totaling \$2,194 per month. These expenses totaled \$4,454, and when annualized, \$53,448.

For reference number DFD-11, the individual reported monthly expenses totaling \$15,148, which when annualized, amounted to \$181,776, on the SFS, for which no supporting documentation was provided. We noted that the \$15,148 unsupported expenses included legal fee payments of \$8,000.

For reference number DFD-32(b), the individual reported monthly expenses totaling \$19,250, which when annualized, amounted to \$231,000, on the SFS, for which no supporting documentation was provided. We noted that the \$19,250 unsupported expenses included monthly mortgage payments of \$6,000.

For reference number DFD-47, the SFS identified mortgage payments of \$5,000 per month, food expenses of \$600 per month, utilities of \$1,000 per month, and insurance premium of \$500 per month. We noted documentation (other than for the food expenses) could have been obtained. The unsupported expenses, excluding the food, totaled \$6,500, and when annualized, amounted to \$78,000.

For reference number DFD-52, the individual reported monthly expenses totaling \$17,606, which when annualized, amounted to \$211,272, on the SFS, for which no supporting documentation was provided. We noted that the \$17,606 unsupported expenses included monthly rental payments of \$4,100. Enforcement indicated that they had discussed the individual's financial condition with the Court-Appointed Receiver, but provided no documentation to support this contention.

For reference number DFD-30, the SFS identified mortgage/rent of \$1,757 per month, utilities of \$580 per month, loan payments of \$1,000 per month, real estate taxes of \$160 per month, credit card payments of \$400 per month, and medical expenses of \$650 per month. These expenses, for which no supporting documentation was provided, but which given the sums involved, should have been verified, totaled \$4,547, and when annualized, amounted to \$54,564.

For reference number DFD-39, the SFS identified utilities of \$1,000 per month; however the documentation supported only \$683.87, leaving \$316.13 unsupported. Also, no supporting documentation was provided for mortgage/rent of \$1,500 per month, food expenses of \$2,000 per month, loan payments of \$700 per month, real estate taxes of \$500 per month, insurance premiums of \$200 per month, monthly medical expenses of \$200, automobile expenses of \$700 per month, college tuition of \$3,900 per month, and health insurance premiums of \$400 per month. Given the sums involved, supporting documentation should have been obtained. These expenses totaled \$10,416.13 and when annualized, amounted to \$124,993.56.

For reference number DFD-43, the individual reported monthly expenses totaling \$10,300, which when annualized, amounted to \$123,600, on the SFS, for which no supporting documentation was provided. We noted that the \$10,300 unsupported expense included monthly rental payments of \$4,000. According to Enforcement, they verified that the individual is subject to an IRS payment plan (\$3,000 per month), reviewed the individual's credit report to determine the reasonableness of the credit card and revolving debt (\$17,000), and verified that the individual rented a home, although they provided no documentation to support these contentions.

For reference number DFD-15, the SFS identified mortgage/rent of \$915 per month, food expenses of \$350 per month, utilities of \$495 per month, loan payments of \$988 per month, insurance premiums of \$588 per month, automobile expenses of \$175 per month, and business expenses of \$4,835 per month. These expenses, for which no supporting documentation was provided, but which given the sums involved, should have been verified, totaled \$7,996 (excluding the food), and when annualized, amounted to \$95,952.

**Small Monthly Expenses**

For the 14 instances listed in Table 8(b), Enforcement stated that the expenses appeared to be reasonable. Thus, they did not obtain supporting documentation. However, it is worth noting that the Commodity Futures Trading Commission (CFTC) requires persons under investigation to provide “True and exact copies of all monthly bills/statements for the following household expenses for the past 3 months: gas; electric; water; automobile and other transportation expenses; telephone; cable; loan payments (car, etc.); insurance premiums; subscriptions; tuition; installment payments; and dues.”<sup>19</sup>

**Table 8(b). Small Monthly Expenses not Supported by Documentation (Annualized)**

Reference Numbers	Amount Waived	Annualized Unsupported Expenses
DFD-36	\$ 1,573,825.24	\$ 33,000.00
DFD-14	283,097.00	25,164.00
DFD-17	45,584.00	39,600.00
DFD-31	1,615,774.83	32,232.00
DFD-37	1,391,715.83	39,696.00
DFD-42	392,385.39	18,024.00
DFD-46	231,633.00	11,280.00
DFD-40	521,580.00	24,600.00
DFD-41	447,600.00	19,092.00
DFD-23	645,945.00	20,796.00
DFD-12	297,559.00	5,520.00
DFD-7	6,918,335.00	24,300.00
DFD-26	708,521.00	20,676.00
DFD-50	115,000.00	34,680.00
<b>Total</b>	<b>\$15,188,555.29</b>	<b>\$348,660.00</b>

Source: Generated by Regis & Associates, PC, based on information provided by Enforcement.

<sup>19</sup> CFTC Form 12, Attachments to Financial Disclosure Statement, approved May 2001 at pages 22-23.

The specific factors involved in these cases are described below:

For reference number DFD-36, the SFS identified utilities of \$1,150 per month, lawn care payments of \$600 per month, and monthly travel payments of \$1,000 per month. These expenses totaled \$33,000 when annualized.

For reference number DFD-14, the SFS identified utilities of \$625 per month, food expenses of \$450 per month, insurance premiums of \$468 per month, medical/dental insurance of \$179 per month, auto expenses of \$260 per month, and other expenses of \$115 per month. These expenses totaled \$25,164 when annualized.

For reference number DFD-17, the SFS identified mortgage/rent of \$1,600 per month, utilities of \$500 per month, insurance premiums of \$400 per month, automobile expenses of \$300 per month, and child care expenses of \$500 per month. These expenses totaled \$39,600 when annualized.

For reference number DFD-31, the SFS identified mortgage/rent of \$1,800 per month, food expenses of \$300 per month, utilities of \$150 per month, car insurance of \$50 per month, and car lease payments of \$386 per month. These expenses totaled \$32,322 when annualized.

For reference number DFD-37, the SFS identified rent of \$1,350 per month, food expenses of \$600 per month, utilities of \$490 per month, insurance of \$285 per month, restitution of \$500 per month, and life insurance premiums of \$83 per month. These expenses totaled \$39,696 when annualized.

For reference number DFD-42, the SFS identified medical expenses of \$400 per month, automobile expenses of \$250 per month, real estate taxes of \$152 per month, income taxes of \$500 per month, house maintenance expenses of \$100, income taxes of \$100 per month, and entertainment expenses of \$100. These expenses totaled \$18,024 when annualized. Enforcement stated that they discussed the individual's financial condition with the Court-Appointed Receiver, although provided no documentation to support this contention.

For reference number DFD-46, the SFS identified insurance of \$500 per month, automobile expenses of \$150 per month, and miscellaneous expenses of \$290 per month. These expenses totaled \$11,280 when annualized.

For reference number DFD-40, the SFS identified utilities of \$1,050 per month and insurance premiums of \$1,000 per month. These expenses totaled \$24,600 when annualized.

For reference number DFD-41, the SFS identified utilities of \$550 per month and insurance premiums of \$1,041 per month. These expenses totaled \$19,092 when annualized.

For reference number DFD-23, the SFS identified utilities of \$285 per month, real estate taxes of \$165 per month, insurance premiums of \$331 per month, medical expenses of \$514 per month, homeowner's dues of \$150 per month, and auto loan payments of \$288 per month. These expenses totaled \$20,796 when annualized.

For reference number DFD-12, the SFS identified office utilities of \$400 per month, and insurance payments of \$60 per month. These expenses totaled \$5,520 when annualized.

For reference number DFD-7, the SFS identified medical expenses of \$200 per month, real estate taxes of \$225 per month, automobile expenses of \$400 per month, church tithes of \$550 per month, orthodontist expenses of \$150 per month, and tuition fees of \$500 per month. These expenses totaled \$24,300 when annualized. According to Enforcement, their assessment was influenced by the fact that the individual had been sentenced to a substantial prison term.

For reference number DFD-26, the SFS identified mortgage/rent of \$406 per month, utilities of \$250 per month, payments on loans of \$265 per month, real estate taxes of \$100 per month, insurance premiums of \$200 per month, medical expenses of \$450 per month, and telephone expenses of \$52 per month. These expenses totaled \$20,676 when annualized.

For reference number DFD-50, the SFS identified utilities of \$890 per month, insurance premiums of \$200 per month, medical expenses of \$530 per month, and transportation expenses of \$1,270 per month, which given the sums involved, should have been verified. These expenses totaled \$2,890, and when annualized, amounted to \$34,680.

**Recommendation 3:**

Enforcement should clarify its internal control policies and procedures regarding when supporting documentation, such as receipts, vendor invoices, pay stubs, etc. should be obtained and retained for the assets, liabilities, income, and expenses shown in the Sworn Financial Statements and undertake actions to ensure that staff comply with these clarified procedures.

## Finding 4: Sworn Financial Statements Should be Retained, Signed, and Notarized for all Defendants/Respondents

“The SFS is the foundation for deciding to recommend a waiver. Defendants who want the Commission to waive payment generally must submit an SFS.”<sup>20</sup> The SFS are provided in two forms: one for individuals and the other for entities. The forms for both individuals and entities list examples of the types of assets, liabilities, income, and expenses, and are formatted to encourage a defendant/respondent to fill out completely the information requested, as well as highlight for the staff any information that is missing. The staff is required to check that the defendant/respondent specified the date of the statement, filled in all columns of information, signed the necessary consent, obtained a notarized signature on the SFS and the consents, and attached all required supporting documents. We identified one instance where the SFS was not provided as part of the defendants/respondents’ case files. We further found that the SFS for one defendant/respondent was not signed and notarized. Tables 9 and 10 identify the two cases in which the SFS were not included in the case files or signed and notarized.

**Table 9. SFS not Provided**

Reference Numbers	Amount Waived
DFD-18	\$ 5,623,290.00
<b>Total</b>	<b>\$5,623,290.00</b>

Source: Generated by Regis & Associates, PC, based on information provided by Enforcement.

**Table 10. SFS not Signed and Notarized**

Reference Numbers	Amount Waived
DFD-30	640,704.00
<b>Total</b>	<b>\$640,704.00</b>

Source: Generated by Regis & Associates, PC, based on information provided by Enforcement.

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<sup>20</sup> This was noted in Enforcement’s policies and procedures governing the disgorgement waiver process (at page 2).

Pursuant to the Commission’s Rule of Practice 630(b),<sup>21</sup> “any respondent who asserts an inability to pay disgorgement, interest, or penalties may be required to file a sworn financial disclosure statement and to keep that statement current. The financial statement shall show the respondent’s assets, liabilities, income or other funds received, and expenses or other payments ....” Additionally, in order for the assertions in the financial statements to be recognized as having been provided under oath, the defendant/respondent making the assertions must sign the financial statements, and must appear before a notary who will attest to their identity.<sup>22</sup>

We found that Enforcement was not always in compliance with its procedures for obtaining signed and notarized Sworn Financial Statements, which may raise concerns about the reasonableness and reliability of the SFS. In these few cases, Enforcement inappropriately recommended the disgorgement waivers for the subject defendants/respondents, without utilizing a suitable means of verification to validate the defendants/respondents’ request for disgorgement waivers.

**Recommendation 4:**

Enforcement should undertake appropriate actions to ensure that Sworn Financial Statements from all defendants/respondents who request disgorgement waivers are retained. We further recommend that Enforcement undertake appropriate actions to ensure that all Sworn Financial Statements are signed and notarized.

**Finding 5: The “Checklist for Maintaining, Reviewing, and Confirming Sworn Financial Statements (SFS)” Should be Retained and Signed by a Supervisor**

While reviewing the SFS, the “Checklist for Maintaining, Reviewing, and Confirming Sworn Financial Statements” (the Checklist) is required to be completed and signed by an Enforcement supervisor. The Checklist ensures that Enforcement consistently keeps all necessary records and documents the scope of the staff review. In addition, a copy of the completed Checklist must be maintained in the appropriate office files. Our review disclosed 18 instances where the Checklists were not provided. Also, we noted six

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<sup>21</sup> 17 C.F.R. § 201.630(b).

<sup>22</sup>This was noted in Enforcement’s policies and procedures governing the disgorgement waiver process (at page 4).

instances where the Checklists were not signed by an Enforcement supervisor. Tables 11 and 12 identify the 24 cases in which Checklists were not provided or were not signed by the Supervisors.

**Table 11. Checklist not Provided**

<b>Reference Numbers</b>	<b>Amount Waived</b>
DFD-48	\$ 151,898.11
DFD-20	2,564,987.00
DFD-9	1,365,711.00
DFD-19	2,589,987.00
DFD-36	1,573,825.24
DFD-31	1,615,774.83
DFD-13	284,385.82
DFD-32(a)	9,941,200.00
DFD-32(b)	9,941,200.00
DFD-47	196,367.00
DFD-3(b)	320,000.00
DFD-3(a)	320,000.00
DFD-3(c,d)	320,000.00
DFD-33(b)	5,233,746.00
DFD-1	13,591,889.00
DFD-22	845,440.95 <sup>23</sup>
DFD-49	134,524.00
DFD-7	6,918,335.00
<b>Total</b>	<b>\$47,328,070.95<sup>24</sup></b>

Source: Generated by Regis & Associates, PC, based on information provided by Enforcement.

<sup>23</sup> In this waiver case, the staff relied on the entity's financial statements and not the SFS and therefore maintained that they did not need to complete the SFS checklist.

<sup>24</sup> Reference number DFD-32 involves two defendants/respondents who received combined waivers totaling \$9,941,200.00. Reference number DFD-3 involves three defendants/respondents who received combined waivers totaling \$320,000.00. Therefore, these amounts were each counted once in the computation of the total amount.

**Table 12. Checklist not Signed by Supervisor**

<b>Reference Numbers</b>	<b>Amount Waived</b>
DFD-21	\$1,716,590.00
DFD-46	231,633.00
DFD-51	39,848.00
DFD-29	601,314.62
DFD-8	2,902,519.00
DFD-15	181,822.00
<b>Total</b>	<b>\$5,673,726.62</b>

Source: Generated by Regis & Associates, PC, based on information provided by Enforcement.

Pursuant to the procedures (page 3), “it is important that the staff document its review of the SFS. To that end, while reviewing the SFS, the staff must also complete Exhibit 1, the ‘Checklist for Maintaining, Reviewing, and Confirming SFS.’ The Checklist will ensure that the Division consistently keeps all necessary records and documents the scope of the staff review. A copy of the completed Checklist must be kept in the branch files.”

We found that Enforcement did not implement adequate internal controls to ensure proper administration and oversight of its disgorgement review process, which requires the Checklists to be always completed and signed by a supervisor.

**Recommendation 5:**

Enforcement should undertake appropriate actions to ensure that the Checklist is always retained and signed by the appropriate supervisor for disgorgement waiver cases.

**Finding 6: Credit Reports, Bank Statements, and/or Income Tax Returns for all Defendants/Respondents Should be Retained and/or Signed**

When recommending a disgorgement waiver, the staff attorneys are required to obtain credit reports. The staff attorneys must obtain the defendant/respondent’s written consent to obtain the credit report, and then compare the information on it to the SFS, and question discrepancies. In addition, the bank statements and income tax returns, including the schedules and attachments associated with them, are required. The staff

attorneys must compare these documents to the SFS and examine what appear to be inconsistencies or issues. Such issues may include tax return schedules demonstrating the existence of a safe deposit box, dividend income, interest income, capital gains and assets not reported on the SFS. During our review of the required supporting documentation, we noted that credit reports, bank statements, and income tax returns were not provided for 15 of the 72 defendants/respondents. This hampers Enforcement's ability to corroborate a person's stated financial condition. We further noted 19 instances where the income tax returns were not signed by the defendants/respondents, and as a result, we were unable to determine the authenticity of the returns.

Additionally, we noted that a similar finding was identified in the OIG's Audit Report 384, dated January 18, 2005. Tables 13 and 14 identify 35 cases in which credit reports, bank statements, and income tax returns were not provided or were not signed by the defendants/respondents.<sup>25</sup>

With regard to the credit reports, bank statements, and income tax returns that were not provided, Enforcement stated that they were sure that most of those documents were obtained, however, copies of those documents were not retained.

As a result of the income tax returns being unsigned, we were unable to determine the authenticity of those documents. Enforcement stated that they did not deem it necessary for the defendants/respondents to submit signed copies of their income tax returns because the income tax returns only serve as support for the income items reported on the SFS. Thus, as long as the SFS are signed and notarized, under penalty of perjury, the defendants/respondents would provide authentic income tax returns.

However, the review found instances where the defendants/respondents failed to either provide the SFS or signed and notarized SFS. Thus, it would be an added control measure for Enforcement to require defendants/respondents to provide signed copies of their income tax returns.

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<sup>25</sup> In some cases, Enforcement did not obtain a copy of a tax return because the individual did not have a copy either because a return was not filed or kept. Enforcement's procedures (at page 13, footnote 14) require that the staff confirm with the IRS that a tax return was not filed or obtain a copy. This requirement was not always followed (e.g., DFD-12).

**Table 13. No credit reports, bank statements, or income tax returns provided**

Reference Numbers	Amount Waived
DFD-2	\$ 881,000.00 <sup>26</sup>
DFD-20	2,564,987.00
DFD-9	1,365,711.00
DFD-19	2,589,987.00
DFD-24	223,665.32
DFD-31	1,615,774.83
DFD-42	392,385.39
DFD-47	196,367.00
DFD-40	521,580.00
DFD-25	222,040.00
DFD-12	297,559.00
DFD-49	134,524.00
DFD-30	640,704.00
DFD-18	5,623,290.00
DFD-35	2,121,871.76
<b>Total</b>	<b>\$19,391,446.30</b>

Source: Generated by Regis & Associates, PC, based on information provided by Enforcement.

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<sup>26</sup> This exception (i.e., the lack of a tax return) for DFD-2 is also discussed in Finding 3 at Table 6.

**Table 14. Income tax returns not signed by the defendants/respondents<sup>27</sup>**

<b>Reference Numbers</b>	<b>Amount Waived</b>
DFD-53	\$ 18,308.00
DFD-11	398,288.00
DFD-42	392,385.39
DFD-52	31,266.75
DFD-46	231,633.00
DFD-51	39,848.00
DFD-8	2,902,519.00
DFD-45	315,300.00
DFD-25	222,040.00
DFD-38	906,326.65
DFD-16	69,004.00
DFD-33(a)	5,233,746.00
DFD-33(b)	5,233,746.00
DFD-6	15,565,511.00
DFD-7	6,918,335.00
DFD-35	2,121,871.76
DFD-32(a)	9,941,200.00
DFD-32(b)	9,941,200.00
DFD-36	1,573,825.24
<b>Total</b>	<b>\$46,881,407.79<sup>28</sup></b>

Source: Generated by Regis & Associates, PC, based on information provided by Enforcement.

Pursuant to Enforcement’s procedures (pages 4 through 5), “the staff must obtain a credit report on each defendant seeking a waiver.” Furthermore, the procedures state, “The SFS requires the defendant to attach copies of the following documents to the SFS:

- Federal income and gift tax returns, including schedules and attachments associated with them;
- Any financial statement prepared by the defendant, including bankruptcy schedules; and
- Loan Documents.”

<sup>27</sup> In several instances (DFD-36, DFD-11, DFD-53, DFD-35, and DFD-8), the tax return was signed (or stamped) by the preparer, but not by the individual.

<sup>28</sup> Reference numbers DFD-33 and DFD-32 each involve two defendants/respondents who received combined waivers totaling \$5,233,746.00 and \$9,941,200.00 respectively. Therefore, these amounts were counted once in the computation of the total amount.

The procedures also state (page 5), “With respect to a defendant whose disgorgement equals or exceeds \$100,000, in addition to the documents required above, the defendant must provide copies of the following:

- Brokerage and commodities account statements; and
- Bank and other financial institution account statements.”

We found that Enforcement did not always comply with these procedures and as a result, in those instances, disgorgement waivers for the subject defendants/respondents were based solely on the defendants/respondents’ unsupported SFS.

**Recommendation 6:**

Enforcement should undertake appropriate actions to ensure that credit reports, bank statements, and income tax returns are always retained in all defendants/respondents’ case files and comply with its procedures regarding obtaining tax returns. We further recommend that Enforcement consider requiring the income tax returns to be signed by the defendants/respondents to ensure authenticity.

**Finding 7: Public Database Searches Should be Performed for the Defendants/Respondents**

Enforcement retained a contractor to provide the staff attorneys with information regarding the defendants/respondents from the contractor’s database. Access to the information is obtained through Autotrack, which is used to perform credit checks on individuals. The company is able to provide information such as aliases and name changes, safe deposit box information, property ownership, names of ex-spouses, mortgages and property tax records, and motor vehicle information. Every office has at least one designated Autotrack technician to assist the staff attorneys in obtaining the database search information for the defendants/respondents. Additionally, the staff attorneys must search Lexis/Nexis and the internet for information about the defendants/respondents. These resources provide useful leads to further verify the accuracy of the financial information provided by the defendants/respondents on the SFS. The staff attorneys must compare the information obtained from the database searches to the SFS and question discrepancies.

Our review of the defendants/respondents’ case files identified only one instance where a public database search was not performed. In this instance,

the defendant/respondent’s SFS assertions were not corroborated to a public database to question discrepancies and identify hidden assets. Table 15 identifies the one instance noted where a public database search was not performed.

**Table 15. No Public Database Search**

Reference Number	Amount Waived
DFD-19	\$2,589,987.00
<b>Total</b>	<b>\$2,589,987.00</b>

Source: Generated by Regis & Associates, PC, based on information provided by Enforcement.

Pursuant to Enforcement’s procedures (page 4), “the staff must compare information from the database to the SFS and question discrepancies.” Although overall, Enforcement was compliant with these requirements in all but one instance, it may be worthwhile to review its procedures to ensure that public database searches are always conducted.

**Recommendation 7:**

Enforcement should review its internal control policies and procedures to ensure that public database searches are performed for all defendants/respondents.

**Finding 8: Formal Training Programs Should be Instituted for Staff Attorneys Responsible for Reviewing the Financial Records of Defendants/Respondents**

Based on our discussions with Enforcement personnel, we noted that the staff attorneys are not provided formal training on the process of determining when waiver recommendations are appropriate. Providing formal training for the staff attorneys would build a comprehensive understanding of the disgorgement waivers review process. Given the complexity and the level of sensitivity, it is critical to provide formal training to explain the different aspects of the disgorgement waiver review process and explain how to analyze financial information. We further note that a similar condition was reported in the OIG’s Audit Report 384, dated January 18, 2005.

Pursuant to Enforcement’s procedures (at page 2), “during an investigation, the staff’s principal focus is on liability and the merits of the case. However,

the staff may also begin considering a potential defendant's financial condition and ability to pay." In order to consider a defendant/respondent's financial condition and ability to pay, the staff attorneys should be trained in evaluating the SFS and identifying the facts and circumstances that warrant waiver recommendations.

Enforcement maintained that on-the-job training was adequate preparation for the staff attorneys and that they recently included a session on waivers in their fall training program. However, without formal periodic training, the staff attorneys are unable to properly analyze the financial information and make an assessment of the defendants/respondents' financial position.

**Recommendation 8:**

Enforcement should clarify their internal control policies and procedures to ensure that the staff attorneys receive periodic formal training in the disgorgement waiver process.

## Acronyms

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CFTC	Commodity Futures Trading Commission
DFD	Defendant/Respondent
FY	Fiscal Year
OIG	Office of Inspector General
SFS	Sworn Financial Statements

## Schedule of Cost Savings

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**Table 16. Underreported Assets**

<b>Reference Numbers</b>	<b>Amount Waived</b>	<b>Cost Savings</b>
DFD-46	\$ 231,633.00	\$ 12,533.78
DFD-3(b)	320,000.00	373,704.00
<b>TOTAL</b>	<b>\$944,018.39</b>	<b>\$386,237.78</b>

Source: Generated by Regis & Associates, PC, based on information provided by Enforcement

## List of Recommendations

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**Recommendation 1:**

Enforcement should undertake appropriate actions to ensure that staff comply with its procedures and consider payment plans and partial waivers in situations where defendants/respondents have the ability to pay some portion of the disgorgement amount.

**Recommendation 2:**

Enforcement should undertake appropriate actions to ensure that it reviews the defendants/respondents' financial information for accuracy prior to recommending a disgorgement waiver.

**Recommendation 3:**

Enforcement should clarify its internal control policies and procedures regarding when supporting documentation, such as receipts, vendor invoices, pay stubs, etc. should be obtained and retained for the assets, liabilities, income, and expenses shown in the Sworn Financial Statements and undertake actions to ensure that staff comply with these clarified procedures.

**Recommendation 4:**

Enforcement should undertake appropriate actions to ensure that Sworn Financial Statements from all defendants/respondents who request disgorgement waivers are retained. We further recommend that Enforcement undertake appropriate actions to ensure that all Sworn Financial Statements are signed and notarized.

**Recommendation 5:**

Enforcement should undertake appropriate actions to ensure that the Checklist is always retained and signed by the appropriate supervisor for disgorgement waiver cases.

**Recommendation 6:**

Enforcement should undertake appropriate actions to ensure that credit reports, bank statements, and income tax returns are always retained in all defendants/respondents' case files and comply with its procedures regarding obtaining tax returns. We further recommend that Enforcement consider requiring the income tax returns to be signed by the defendants/respondents to ensure authenticity.

**Recommendation 7:**

Enforcement should review its internal control policies and procedures to ensure that public database searches are performed for all defendants/respondents.

**Recommendation 8:**

Enforcement should clarify their internal control policies and procedures to ensure that the staff attorneys receive periodic formal training in the disgorgement waiver process.

## Management Comments

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### MEMORANDUM

**TO:** David Kotz, Inspector General

**FROM:** Linda Chatman Thomsen, Director of the Division of Enforcement

**SUBJECT:** Enforcement's Response to Draft Report, Audit of Disgorgement Waivers, Report No. 452, dated December 31, 2008

**DATE:** February 3, 2009

This memorandum is in response to Audit Report No. 452 regarding disgorgement waivers. Recommending a waiver to the Commission is a matter we take very seriously. The Division of Enforcement thoroughly considers all aspects of each case before recommending a waiver. We have given guidance to our staff in this area which balances the need to assure that the recommendation to the Commission is appropriate, with the wise use of our limited resources. In order to receive a waiver, a defendant must submit a sworn financial statement, which defendant must sign under penalty of perjury, a requirement we administer strictly. We then ask our staff to carefully review the sworn financial statements so that we can make an informed judgment as to the appropriate recommendation. However, we do not ask the Enforcement staff to enter into a time intensive audit of the sworn financial statements of the defendants.

Indeed, considering the large number of urgent matters directed to the Division of Enforcement, it seems highly unlikely that the Commission would find it prudent to direct us to spend more of our few resources in this area. Waivers make up a relatively small percentage of our workload and thus, it is critical that we use our resources in this area judiciously. We believe that the balance we have struck is extremely effective and useful. We do not believe it is beneficial to use our limited resources chasing verification of a few hundred dollars the Defendant spends on reasonable living expenses, such as food and which would only prove that a defendant is further in debt. Likewise it seems illogical that the Commission would choose to have us litigate a matter, instead of settling with a waiver, because a defendant could not document his reasonable food and

living expenses. In fact, in our guidance to the staff, we do not require our staff to obtain documentation for reasonable monthly expenses.

We – and the Commission- must consider practical issues in making waiver decisions, such as the defendant’s overall ability to pay, litigation risk, mitigating circumstances and resource considerations. In the first finding, the results properly indicate that in 96% of the waivers reviewed, Enforcement granted waivers to individuals with no ability to pay any portion of the amount waived. However, the Report then focuses on three defendants and cherry picks assets and income of these defendants and then determines that based on this narrow analysis these defendants could have paid more. For instance the Report states that DFD-40 had a positive net worth of \$18,115 and therefore determines that a payment plan where the defendant paid more money over time was a viable option. This conclusion simply ignores the overall ability of this defendant to pay more and ignores that Enforcement is already receiving a payment from this defendant. This is a **partial** waiver case where the defendant paid \$85,000 and therefore was paying more in disgorgement than his net worth. In order to pay this amount the individual borrowed from his home equity line of credit. This settlement was negotiated before a magistrate judge, who agreed with the defendant’s sworn financial statement which showed that the defendant had no present income. It is hard for us to understand how the Report can conclude that this individual had an ability to make payments overtime which would have to come from an income source that he did not have. We continue to view this as an excellent settlement. The limits of the Report’s narrow analysis can be seen when viewed in the context of the defendant’s overall ability to pay. We take similar issue with the other case listed in the first finding. The case, which involved DFD 3(a) and DFD 3(b), is a matter where we had already collected and returned over 90% of the investor’s funds. Clearly, this is also a case that when considered in its entirety demonstrates the staff’s and the Commission’s proper judgment.

As analyzed below we disagree with the two items the Report contends are underreported in Finding 2. For instance, DFD-46 is a **partial waiver case** where defendant paid \$47,000 and \$231,633 was waived. In recommending this waiver, staff took into account that fact that defendant was unemployed and incarcerated, unlikely to ever regain his pre-incarceration earning-power, and that his current assets would likely be depleted by litigation costs as well as a \$75,000 debt to his former employer. The Report states that \$12,533 in assets in defendant’s bank statement were not included in the individuals final SFS. The \$12,533 was reflected in defendant’s bank account statements at a date six weeks before defendant created his SFS. Staff believes that by the time defendant submitted his SFS, he had depleted the \$12,533 account balance because defendant was unemployed and about to report to prison, and that is why it was not included in his SFS. Therefore, we do not believe that these assets were underreported.

As to the findings regarding adequate documentation of assets, liabilities, income and expenses it is not surprising that the lists for assets and income, items against which you can collect, are short and the lists for expenses and liabilities are longer. Once the staff has determined that a defendant lacks the income and assets from which to pay

disgorgement or penalties, they generally do not expend unnecessary resources tracking down all of the defendant's expenses, items which can only further prove a defendant's inability to pay. In fact, such an effort seems wasteful. Rather, with expenses, we expect our staff to do a cost/benefit analysis and make a reasonable determination as to what should be further researched in terms of the defendant's ability to pay. We think the Report's criticism as to these matters is further evidence of the limitations of its narrow analysis that only looks at items in isolation, rather than in the context of the defendant's overall ability to pay. We believe that what the Report has found in Finding 3 is the failure of some of our staff to maintain documentation. We note that as to the findings for assets and income, four of the seven items for assets, and five of the six items for income, come from one office which was not in the habit of retaining documentation after reviewing it. We understand that this documentation must be maintained for you to audit and we will instruct our staff to maintain all documentation which formed the basis of their waiver recommendation.

All our waiver cases are thoroughly and carefully considered by Enforcement staff and by the Commission before they are approved. As further explained elsewhere in this letter, our waiver recommendation would not have changed based on anything included in this Report. Furthermore, in many of the cases, defendant's financial condition continued to deteriorate after our cases were filed – such as defendants who have since filed for bankruptcy and gone to prison.

Furthermore, since we firmly believe that our waiver recommendation would not have changed in any of these matters, we do not agree with the Report's attribution of cost savings to this audit. This statement does not take into account the cost of hiring the contractor for this audit or the hundreds of Enforcement staff hours that were spent making corrections to prior versions of this Report. Further, we note that only two cases are presented as having a cost savings; one item the cost savings is listed as just over \$12,000 and for the other item the cost savings listed is \$50,000 greater than the actual amount waived.

While the Report's findings would not have changed our waiver recommendations in any of the cases cited, the Report's generally phrased recommendations are actions which we believe are appropriate and are, for the most part, actions which we are currently taking. Therefore we acquiesce with the Report's recommendations.

### *Case-by-Case Analysis*

The Report lists waivers which it believes are problematic. When Enforcement is considering recommending a waiver to the Commission, we look at the case as a whole and take into account the defendant's entire financial condition, litigation risk, mitigating circumstances, Commission resources and views of the court and therefore we believe it is useful to consider these cases from this broader perspective below. As can be seen, we

do not believe that more money would have been obtained by the Commission in any of these matters.

- **DFD-17**

- This is a **partial waiver case** where Defendant paid \$65,000 of the total disgorgement and prejudgment interest amount of \$110,583.80 (disgorgement of \$95,109 and prejudgment interest of \$15,474.80). In fact, the Defendant effectively paid all of his available savings to satisfy the \$65,000 portion of the judgment, and had no resources or accessible assets to pay the remainder. Defendant was unemployed with no income and had been living off of his savings for over one year. The Defendant had only \$71,000 in assets against which we could collect.
- The Defendant's prospect for future employment was uncertain because the case against him involved allegations of fraud and he had already been terminated from two jobs as an auditor due to the allegations.
- The Report states that staff did not get documentation to support defendant's monthly expenses of \$1,600 for a mortgage, utilities of \$500, insurance premiums of \$400, auto expenses of \$300 and child care expenses of \$500 per month. All of these appear reasonable, and it would not have been a wise use of our limited resources to pursue this further.
- Therefore, our waiver analysis remains the same. This waiver was totally appropriate.

- **DFD-53**

- This is a case involving a waiver of \$18,308 (disgorgement of \$10,000 and prejudgment interest of \$8,308).
- This Defendant was a 77 year old man with a monthly net income of negative (\$354) and dubious future earning prospects. Defendant has since been barred from the industry and thus no longer receives \$1000 per month in commissions. Furthermore, his wife was incurring significant medical expenses at the time of the waiver.
- The Report states that the Defendant had unsupported credit card liabilities of \$6,663. The Defendant represented that these constituted amounts owed by him and his wife together, and that representation appeared reasonable.
- The Report states that this defendant had large monthly expenses not supported by documentation – mortgage/rent of \$660 a month, legal expenses of \$1000 a month, credit card payments of \$600 per month, and miscellaneous expenses of \$2,194 per month. Taking the Defendant's financial condition as a whole, this waiver and the resources we expended on it appear reasonable.
- Therefore, our waiver analysis remains the same. This waiver was totally appropriate.

- **DFD-11**
  - This is a **partial waiver case** where defendant with a negative net worth and a negative net income paid \$50,000 of the total disgorgement and prejudgment interest amount of \$448,324 (disgorgement of \$408,940 and prejudgment interest of \$39,384). Although Defendant had a positive net worth of \$372,033, Massachusetts state law protected his assets with a value totaling approximately \$514,628, leaving him with a negative net worth for purposes of the waiver analysis. Included in the list of assets protected from collection by us is his retirement account of \$86,781 and his primary residence valued at \$427,847.  
The Report alleges that there are large monthly expenses that are undocumented, \$15,148 which included \$8000 of legal fees per month. The staff considered this expense at the time of the waiver recommendation and concluded that for legal fees in a litigated matter these did not seem exorbitant or suspicious.
  - Therefore, our waiver analysis remains the same. This waiver was totally appropriate.
  
- **DFD - 13**
  - This is a case involving a waiver of \$284,385.82 (\$225,000 in disgorgement and \$59,385.82 in prejudgment interest) for a defendant with a negative net worth of (\$261,082).
  - The Report lists this case as having underreported assets of \$14,900. The staff found this asset, which was a vacant lot in NJ, through a LEXIS search at the time of the waiver analysis. Defendant told staff that he sold this property to a partner for \$6,000. Staff identified this potential asset in a footnote in the Action Memo to the Commission and considered it in connection with our recommendation to grant a waiver to Defendant. However, since defendant's net worth not including the property was negative (\$261,082), the waiver analysis would not have changed even if staff included the property as an asset.
  - The \$8,000 of unsupported liabilities listed in the Report for this Defendant refers to accrued real estate taxes of \$8,000. In addition to the Choicepoint report and the credit report provided by the defendant, which reflect civil judgments, outstanding credit card debts, and other non-mortgage debts, the staff produced a copy of an invoice dated August 2004 for delinquent real estate taxes in the amount of \$6,176.92. The Defendant's final SFS from November 2005 listed the real estate obligation at \$8,000, which seemed reasonable given that additional taxes and interest would have accrued between August 2004 and November 2005.
  - Therefore, our waiver analysis remains the same. This waiver was totally appropriate.

- **DFD-31**
  - This is a **partial waiver case** where the Defendants paid \$1,805,612.60 of the total disgorgement and prejudgment interest amount of \$3,421,387.40 (\$3,269,459 of disgorgement and pre-judgment interest of \$151,928.49).
  - The Report notes that small monthly expenses were not documented, rent of \$1,800, food expenses of \$300 per month, utilities of \$150 per month and car lease payments of \$386 per month. This would not have changed our analysis and from a cost/ benefit perspective we do not believe it is worthwhile for these expenses to be pursued.
  - Therefore, our waiver analysis remains the same. This waiver was totally appropriate
  
- **DFD- 40**
  - This is a **partial waiver case** where the Defendant paid \$85,000 of the total \$521,580 in disgorgement.
  - The Report states that Defendant had a positive net worth of \$18,115 and should have also been considered for a payment plan. At the time the settlement was negotiated before a magistrate judge, Defendant stated, and his SFS supported the fact, that he had no present income and that he would be borrowing from a home equity line of credit to pay this amount. This settlement, which was well over his net worth, was a very good settlement.
  - Furthermore, the Defendant agreed to act a witness against other individuals in our litigation.
  - Therefore, our waiver analysis remains the same. This waiver was totally appropriate.
  
- **DFD-36**
  - The Report indicates that defendant had \$186,079 in liabilities that were not supported by documentation (\$19,725 for an auto loan and \$162,916 in credit card debt). However, most of this discrepancy lies in the fact that \$87,000 of the debt that Defendant listed in his SFS were actually his wife's credit card debts (for which backup was provided). These debts would not appear on Defendant's credit report and since we were not suing Defendant's wife we did not have the legal authority to seek her credit report. These debts were included by defendant because the SFS instructs individuals to include their spouse's information. This is especially appropriate in California, a community property state. The \$19,725 is debt on the wife's car (for which backup was provided). The rest of the discrepancy in his liabilities was between \$35,000 - \$75,000 in credit card debt (for which backup was also provided).
  - Defendant's negative net worth on his SFS was (\$236,626), so even if he had \$35,000 - \$75,000 less in liabilities, he still would not have had money to pay disgorgement. In addition, Defendant was living off his

credit cards because he had no money, so these liabilities were continuing to rise.

- Furthermore, since our case has concluded, Defendant's house was foreclosed on, his car was repossessed, he filed for bankruptcy and the trustee found that he had no assets to distribute. In addition, his company is out of business.
- Therefore, our waiver analysis remains the same. This waiver was totally appropriate.

- **DFD- 49**

- In this **partial** waiver case, Defendant paid \$20,000 and \$134,524 was waived. The Report states that Defendant had \$84,600 in annual expenses (\$7,050 monthly) that were not supported by documentation. We have provided bank statements and credit card statements that support this amount.
- Staff provided hundreds of pages of bank statements and tax returns for each year Defendant filed tax returns. The single item missing is actually the credit report run by the staff after we obtained Defendant's authorization to run a credit report. This report was run but we cannot locate it in our files.
- Therefore, our waiver analysis remains the same. This waiver was totally appropriate.

- **DFD-27**

- We disagree with the Report's finding of undocumented assets of \$23,315 for this Defendant. The staff took significant efforts to determine which vehicles should have been included in the SFS, including conducting its own Autotrak public records search, which the Report fails to acknowledge and which identified each of the vehicles at issue. The first of the three vehicles included in the \$23,315 amount is a vehicle leased by Defendant's wife and thus should not be counted as an asset. Contrary to the findings in the Report, public record documentation of GMAC as the lien holder on the car was provided to OIG. The second vehicle included in the \$23,315 amount is a vehicle valued at \$4,000 that we, in fact, counted as Defendant's vehicle and reported to the Commission in our Action Memo. The third vehicle, the Nissan, belongs to Defendant's adult son, who has the same name, who did not reside with his parents, and thus should not be counted. In total, we identified and questioned Defendant about seven vehicles from public database searches, documents and information that Defendant produced and representations made during in-person interviews with Defendant and his counsel.
- Furthermore, this is a small amount given his large negative net worth of over (\$400,000), and would not have been material to the disgorgement amount that the Commission waived.

- Therefore, our waiver analysis remains the same. This waiver was totally appropriate.
- **DFD 20**
  - The Report states that defendant has "liabilities unsupported by documentation" in the amount of \$11,931.38 involving property management fees on a Canadian condominium. We analyzed this liability in the Action Memorandum to the Commission. Based on the mortgage documents and payments reflected on defendant's bank statements, as well as Defendant's sworn testimony, the staff believes this debt was properly documented. Also, as we made clear to the Commission in our Action Memo, even if you exclude the Canadian property management fees, defendant would still have a negative worth.
  - Furthermore, this is a case where we recommended a **partial waiver** of disgorgement and in fact defendant agreed to pay \$25,000 of the \$2,589,987 in disgorgement and is currently in default on the money ordered to be paid. The staff is in the process of referring this matter for collection.
  - Therefore, our waiver analysis remains the same. This waiver was totally appropriate.
- **DFD 46**
  - In this **partial waiver case**, defendant paid \$47,000 and \$231,633 was waived.
  - In recommending this waiver, staff took into account that fact that defendant was unemployed and incarcerated, unlikely to ever regain his pre-incarceration earning-power, and that his then current assets would likely be depleted by litigation costs as well as a \$75,000 debt to his former employer.
  - The Report states that \$12,533 in assets in individual's bank statement were not included in the individual's final SFS. The \$12,533 was reflected in defendant's bank account statements at a date six weeks before defendant created his SFS. Staff believes that by the time defendant submitted his SFS, he had depleted the \$12,533 account balance and that is why it was not included in his SFS.
  - In light of the defendant's situation it is hard for us to fathom how the Report concludes that we could have collected more money from this defendant and that there was some how a "cost savings" of this amount from the audit.
  - Therefore, our waiver analysis remains the same. This waiver was totally appropriate.

- **DFD -24**

- This was a **partial waiver case** where Defendant paid \$25,000 and \$223,665 was waived. Defendant had a total net worth of negative (\$226,000).
- This is a case where extensive settlement discussions began early but broke down. The case was then scheduled to go to trial and on the eve of trial defendant attempted suicide. Trial was then postponed and the second set of settlement discussions began.
- Defendant's suicide attempt before the trial left him in a mental state where he was unable to work, was unemployed and was meeting his current living expenses through credit card debt and gifts from his parents. Also, Defendant claimed to suffer from a neurological disorder whose treatment caused him to develop a Vicodin addiction.
- The Report notes that "no credit reports, bank statements and income tax returns" were provided. However, defendant provided his required tax returns during the initial settlement discussions around the time the Complaint was first filed. By the time the second round of settlement discussions occurred, Defendant had not filed federal income tax returns since the first discussions. According to SEC guidelines, staff procured an IRS Form 4506-T from Defendant and confirmed this to be the case. Additionally, Defendant did provide credit reports and bank statements with his SFS.
- The Report states that SFS identifies undocumented liabilities of: legal fees in the amount of \$4,500 and medical fees in the amount of \$1,000. For the medical fees, defendant provided staff with a letter from the hospital, stating that the defendant had been admitted in critical condition due to a suicide attempt. He also had submitted evidence of ongoing psychiatric visits and treatment for his depression. As for the legal fees, during the litigation of this case, the individual's defense attorney made a motion with the court to withdraw based on the fact that he was not getting paid so staff knew the origin of the liability.
- Therefore, our waiver analysis remains the same. This waiver was totally appropriate.

**DFD - 44 and DFD - 48**

- In this **partial waiver** the individual defendant, DFD-44, paid \$62,035 and \$351,537 was waived.
- The Report states that auto loans in the amount \$18,275 were not documented. However, given that defendant had a negative net worth of (\$251,756) regardless of those loans, it did not seem material to the waiver issue.
- The entity defendant in this matter, DFD- 48, paid \$50,525. We did not complete a checklist as we should have, however, to place this matter in context, the entity was entirely defunct at the point we settled, and had

only one account, which we took in settlement. The funds paid in settlement were obtained from an account that was frozen by Court order in the litigation, and which constituted the only material cash assets of the Defendant.

- Therefore, our waiver analysis remains the same. This waiver was totally appropriate.

- **DFD - 35**

- The Report criticizes this matter for not having bank statements and some tax returns. However, Staff did obtain a credit report for defendant as well as tax returns for 2003-2006. No bank statements were obtained because defendant represented in his SFS that he had no accounts and was unable to open any accounts because of prior bank and tax deficiencies. The staff was not aware of any evidence contradicting these assertions, nor did defendant's credit report, AutoTrak report or other public records searches indicate that defendant had any bank accounts. Moreover, the staff had the benefit of reviewing defendant's Personal Financial Statement submitted to the U.S. Probation Department and defendant's presentence report which also failed to disclose the existence of any bank accounts and confirmed Defendant's extremely poor financial condition. We list this matter to note that it can not be concluded in all instances where there is missing documentation, that we did not have a clear understanding of the defendant's financial condition.
- Therefore, our waiver analysis remains the same. This waiver was totally appropriate.

- **DFD – 3(a) and (b)**

- The Report states that there is \$373,704 in assets underreported in this \$320,000 waiver case. However, this amount relates to a jointly-held interest in a venture that has not produced income and we do not believe it is properly listed as underreported.
- The Report states that staff should have considered a payment plan because DFD 3(a) had a positive net worth of \$12, 410 and DFD 3(b) had a positive net worth and good credit scores. However, in March 2007, DFD 3(a) reported to the staff that he had a net monthly income of negative (\$1,609.54). As of January 2007, DFD 3(b) also had a negative monthly income and was the sole provider for a family with several young children. DFD 3(b)'s calculated total assets included a heavily encumbered residence and illiquid notes receivable. Furthermore, we already collected and returned over 90% of the investors' funds. A modest payment plan would not have resulted in any meaningful further recovery.
- Therefore, our waiver analysis remains the same. This waiver was totally appropriate.

- **DFD 2**
  - As part of his **partial waiver**, the staff required defendant to agree to make payments totaling \$150,000 within two years – an amount much higher than his negative net worth of (\$67,000) could support.
  - The Report cites unreported income of \$10,655.94. This amount does not reflect under-reported income. This amount reflects a one-time deposit into the defendants’ bank account. We have spoken to bank representatives, who confirmed this fact and have supplied this information.
  - The Report cites a failure to obtain proof that defendant had not filed tax returns and to obtain proof of his \$200,000 in back taxes. The applicant swore on his SFS that he was in the process of preparing those returns and told us that the \$200,000 liability was an estimate only. Accordingly, we explicitly noted on the summary in the Action Memorandum to the Commission that the amount was “Estimated.”
  - Therefore, our waiver analysis remains the same. This waiver was totally appropriate.
  
- **DFD- 16**
  - This is a **partial waiver case** where the disgorgement was paid pursuant to a **payment plan**. Defendant paid approximately \$35,000 and \$ 69,004 was waived.
  - The Report states that liabilities totaling \$443,000 of legal fees, credit card debt of \$24,083 and an installment loan of \$1,000 was unsupported by documentations. Staff did not have documentation for a \$1,000 loan from his mother and this loan was not included as a liability in the summary presented to the Commission. Defendant had a negative net worth of (\$9,429) without these liabilities and as a result staff based the payment plan analysis on his income, assuming a zero net worth.
  - Therefore, our waiver analysis remains the same. This waiver was totally appropriate.
  
- **DFD – 52 and DFD - 42**
  - In this **partial waiver** case, one Defendant paid \$19,000 and \$31,266 was waived and the other Defendant received a waiver for \$392,385.39. The Report states that Defendants have assets not supported by adequate documentation for \$23,595 (DFD-52) and \$419,049 (DFD-42) respectively. Valuations of these assets were verified by document reviews and by interviews of third parties, however we did not retain these documents. The valuation of the one defendant’s home was verified by the Court-appointed Receiver.
  - Therefore, our waiver analysis remains the same. This waiver was totally appropriate.

- **DFD -32(a) and DFD – 32(b)**
  - In this **partial waiver** case, one Defendant paid \$200,000 and one Defendant paid \$260,000 and \$9,941,200 was waived. The Report states that defendant’s assets, liabilities, income and expenses are not supported by adequate documentation.
  - Staff obtained documents concerning key assets listed on each defendant’s SFS. These documents included valuation opinions of key assets, computerized database searches, income tax returns, copies of secured and unsecured notes payable and credit card statements.
  - Additionally, documents concerning the defendants’ assets were obtained as a part of the staff’s investigation and reviewed for the purpose of evaluating the defendants’ representations on their respective SFSs. These documents are currently in the possession of another federal authority. Finally, explanations concerning the valuations of the defendants’ assets were included in the staff’s Action Memo to the Commission.
  - Tax returns for the individual defendants for multiple years were obtained and provided. A credit report for Defendant was obtained by the staff. It was transmitted electronically to the staff and is maintained in computerized form. Bank and brokerage records for defendant and related entities were shipped to Defendant’s counsel’s office in or around May 2007 and reviewed by the staff for the purpose of assessing the accuracy of the disclosures on his SFS. Due to the voluminous nature of the records, copies were not made. Additionally, bank and brokerage records for the individual defendants and their related corporate entities were subpoenaed as a part of the staff’s investigation. The documents were reviewed for the purpose of evaluating the defendants’ SFS. These documents are currently in the possession another federal authority.
  - Therefore, our waiver analysis remains the same. This waiver was totally appropriate.
  
- **DFD – 15**
  - In this \$181,822 waiver case, the Report states that monthly income was not supported by documentation. The staff personally interviewed both defendants to discuss the defendants’ respective monthly income. At the meeting, bank records and income receipts were reviewed and discussed. Staff retained the documents for further review and thereafter returned the originals to the defendants. The staff also reviewed the defendants’ tax returns, consumer credit reports and two computerized database searches to evaluate the reliability of their stated income; many of these documents have been provided.
  - Therefore, our waiver analysis remains the same. This waiver was totally appropriate.

- **DFD – 14**
  - In this **partial waiver case**, defendant paid \$40,000 and \$223,655 was waived. He has paid \$8,710 to date and is continuing to make payments through Treasury, where the debt has been referred.
  - The Report states that \$25,164 in annual expenses was not documented (\$2097 per month).
  - Defendant in this case declared bankruptcy before we submitted our **partial waiver** recommendation to the Commission. This fact is discussed in our action memo to the Commission. Also defendant pled guilty to criminal charges in connection with this fraud in the criminal case. He was also ordered to pay restitution of \$119,936 at a rate of \$100 per month in the criminal case.
  - Therefore, our waiver analysis remains the same. This waiver was totally appropriate.
  
- **DFD – 23**
  - This is a **partial waiver case** where Defendant paid \$45,000 in disgorgement and the remaining balance of \$645,945 was waived. The Report states that defendant's assets of \$57,860 were not supported by adequate documentation. Trial counsel conferred with the court appointed receiver in this case regarding the Defendant's assets and we note that, defendant, age 72, and his wife both suffered from health problems and were living on social security. Thus, in our recommendation to the Commission, we advised that Defendant be allowed to retain some assets to cover the shortfall between income and living expenses.
  - Therefore, our waiver analysis remains the same. This waiver was totally appropriate.
  
- **DFD – 12**
  - In this \$297,559 waiver case, the Report states that Defendant had unsupported monthly expenses of \$460 per month for office expenses and insurance payments. The staff conducted an asset deposition for Defendant regarding assets, expenses and for additional information because Defendant was unable to supply certain past tax returns.
  - In evaluating Defendant's monthly expenses, we recommended that the Commission consider that Defendant had moved out of his home and was living with family members in order to avoid housing costs, and that he was voluntarily attempting to pay back some investors with his limited funds.
  - Therefore, our waiver analysis remains the same. This waiver was totally appropriate.

- **DFD- 21**
  - This was a **partial waiver case** where Defendant paid \$378,435 and \$1,716,590 was waived. The Report claims that there are \$85,000 in liabilities not supported by documentation. In this case, we essentially took every asset that Defendant had that was collectable. In light of this fact, Defendant's liabilities become much less important. Significantly, even if you back out the \$85,000 in undocumented liabilities, Defendant still has a negative net worth of (\$36,449) and has no additional assets with which to satisfy a disgorgement or penalty obligation.
  - With respect to the \$85,000 in liabilities, \$65,000 of this amount is unpaid tax liability. As described in the Action Memo in this case, defendant did not pay income tax or file tax returns for years 2003-2005. The staff independently verified defendant's non-filing status with the IRS, and submitted documentation from the IRS with respect to that status. Given that we verified Defendant's non-filing status, we accepted his estimate of his tax liabilities. However, we specifically notified the Commission that the \$65,000 figure was an estimate in a footnote of the Action Memo.
  - Also, the Report misstated Enforcement's position about the unsupported liabilities in this case. Enforcement's position is that given the individual's high negative net worth, the validity of these unsupported liabilities would not have changed the partial waiver recommendation since Enforcement had already collected every available asset.
  - Therefore, our waiver analysis remains the same. This waiver was totally appropriate.
  
- **DFD – 41 and DFD 50**
  - For DFD 41 the Report states that there are unsupported liabilities of \$9,855 in credit card debt, \$6,850 of medical bills, and \$1,591 in monthly expenses. At the time we recommended the waiver, this defendant was serving a 24 month prison sentence.
  - Furthermore, for DFD-50, the draft Report cites unsupported, annualized monthly expenses of \$34,680 (\$2,890 a month) of \$890 in utilities, insurance premiums of \$200, medical expenses of \$530 per month, and transportation expenses of \$1270. These small amounts would not have changed our waiver analysis and we note that at the time of the recommendation, the defendant suffered debilitating health issues.
  - Therefore, our waiver analysis remains the same. This waiver was totally appropriate.

***Finding 1:***

We disagree with the Report's conclusion that these three defendants could have paid more and we stand by the waivers that were recommended. The Report states that a payment plan should have been considered as to these items. In our waiver guidance we advise the staff that a payment plan may be appropriate in three instances: (1) when the

defendant has **significant** net income, (2) where there are **substantial** illiquid assets, and (3) when there are prospects of **significant** future income. We do not recommend a payment plan merely because a defendant has some ability to pay, rather we require a substantial payment up front and the ability to pay on at least a quarterly basis so that it is reasonable that the defendant has some ability to pay the amount ordered and so that our resources are not wasted on payment plans with little likelihood of success. The Report did not demonstrate any significant ability for these defendants to make a substantial down payment or consistent monthly or quarterly payments but rather substituted its judgment for ours without any concrete examples of how, viewing the defendant's entire financial situation, these defendants could pay pursuant to a payment plan. As to DFD-40 a partial waiver was in fact obtained. This defendant paid \$85,000, which he obtained by going into debt, and which is more than his positive net worth. He also had no present income. It is hard to imagine how this individual is a candidate for a payment plan as the Report suggests. The other item on the Report is a single case involving DFD 3(a) and DFD 3(b), a matter where we had already collected and returned over 90% of the investor's funds. These two defendants had negative net incomes, making a payment plan, as suggest by the Report, highly unlikely.

While the Report is critical of our staff for not considering credit scores we have never directed our staff to base their recommendation on this information. While a person's ability to take on debt is interesting information to take into account, it does not dictate the results of recommending a waiver.

***Recommendation 1:***

While we disagree with the Report's conclusions in finding one, we will remind our staff that payment plans and partial waivers can be appropriate. In fact, in nearly one quarter of the waiver cases reviewed (17 cases), Enforcement recommended a partial waiver to the Commission. We will also continue to ensure, through our memo review process, that cases are appropriately considered for payment plans or partial waivers and comply with our procedures. Therefore, we concur with the Report's recommendation.

***Finding 2:***

The Report next cites two assets that it believes were under-reported. As to DFD-46 the Report states that his bank records show \$12,533.78 more than identified in his SFS. We note that this was a **partial waiver** in that defendant paid \$47,000 of the amount owed and he was unemployed and about to report to prison. As noted above, the bank statement was from a period prior to the SFS and was likely spent during the weeks before the Defendant prepared his SFS, as he had no source of income. As to the other defendant in this section, DFD-3(b), the note that the Report highlights was an interest in a joint venture that was not producing income and we do not agree that this asset was underreported. Therefore, our waiver analysis as to these defendants is unchanged.

***Recommendation 2:***

While we disagree with the basis for this finding, we agree that it is critical that the defendant's financial information be reviewed for accuracy and therefore concur with the recommendation. We believe that this can best be accomplished by reiterating that our staff follow the current guidance and appropriately fill out and follow the checklist.

***Finding 3:***

The Report states the staff did not obtain supporting documentation regarding certain assets, liabilities, monthly income and expenses. We do not agree that the items listed as undocumented assets, represent items from which we could have made collection. As to two of the defendants, DFD-13 and DFD-27, whose questioned assets are a vacant lot and cars, we fully explained these assets to the Commission in the Action Memo and disagree with the Report's conclusions. As to DFD-23, this was a 72 year old defendant who was living on his social security. In the Action Memo to the Commission we suggested that this individual should be allowed to live on his few remaining assets. As to the four remaining items the Report lists, we did not retain documentation, rather we reviewed it and either returned it or gave it to another government agency. We recognize that for your auditing purposes we need to maintain these documents and we will instruct our staff to do so in the future; however, these were not items for which we never obtained documentation.

Next the Report lists liabilities it believes are unsupported by documentation. For a number of these items we had the documentation at the time of the waiver recommendation but we failed to maintain it. As with the same issue detailed in the paragraph ahead we will make certain that in the future our staff maintains these records.

We note that the finding as to underreported income contains one example involving a single \$10,655.94 deposit into Defendant's checking account. We have explained that the bank has stated that this was a one time deposit and therefore was non-recurring income. Since the bank is an independent third party, we believe this is adequate documentation and we do not agree that further documentation was required as stated in the Report. Our waiver guidance explicitly states that "non-recurring income does not necessarily increase a defendant's ability to pay." For the other four items listed in this section they are from an office that previously did not always maintain documentation after the waiver was recommended.

The last issue in this section is monthly expenses. We do not require, and never intended to require, documentation for every expense. We will clarify our guidance if necessary on this matter to emphasize that we do not want staff spending unnecessary resources documenting routine monthly expenses. Instead, our guidance specifically states that we require staff to identify situations where defendants have exorbitant expenses which indicate that they are living opulent life styles or if Defendant's SFS shows that

Defendant is living way beyond his or her means without suffering some consequence. We also want to note that the Report presents expenses as annualized figures, so when it lists expenses of \$5,520 that is a monthly figure of \$460. This hardly seems like a figure that would change our waiver recommendation.

As the Report states many of the unsupported expenses are for items such as food, utilities, rent and insurance. In our view from a cost benefit analysis these expenses were reasonable and did not need to be documented further than the defendants' SFS.

***Recommendation 3:***

We agree that **adequate** supporting documentation must be maintained and we will make clear to our staff the importance of doing this. If necessary, we will clarify our guidance to staff that it is not necessary to collect supporting documentation for every expense in Defendant's SFS. We believe our controls are adequate. We will reiterate to the staff the importance of following the guidance in the checklist and that supervisors ensure this review is properly done.

***Finding 4:***

We agree that the sworn financial statements are the cornerstone of the waiver process. The Report makes limited findings in this section as to one instance where we were not able to produce the SFS and one instance where we were not able to provide a signed and notarized version. This finding shows that we must reiterate to our staff the need to carefully retain documentation.

***Recommendation 4:***

We concur with your recommendation that we obtain a signed and notarized SFS. Based on your limited findings we believe that our current controls are appropriate.

***Finding 5:***

We agree that a checklist must be completed and signed by the supervisor, as it is the key to our internal controls. While in most of the instances you cite the procedures in the checklist were followed, we agree that this documentation must be maintained. We believe that the best way to address this issue is to reiterate to our staff in the Office of the Chief Counsel that they must obtain a copy of the signed checklist in all waiver recommendations before those matters can be placed on the Commission calendar. We will also reiterate to our staff that they maintain a copy of the signed checklist in the case files.

***Recommendation 5:***

We concur in this recommendation and will ensure that the Office of Chief Counsel does not allow any matters to be calendared unless they have first obtained a copy of the signed checklist.

***Finding 6:***

This finding relates to missing credit reports, bank statements and income tax returns. Many of the documents were obtained but we did not maintain a copy. We believe that reiterating to our staff the need to follow the checklist and to retain documentation will address this issue. To the extent the chart implies that all of these documents were missing for all of these matters, we note that typically it was one of these items we could not produce, not the entire list.

The Report also devotes an entire chart to income tax returns which were not signed by the defendant. We disagree that only income tax returns physically signed by the defendant are acceptable. Many returns are filed electronically by an accountant or through computer programs and the copy retained by the defendant may not bear a signature. In light of the fact that copies of the tax return are attached to the sworn financial statement, and in the signature portion of the sworn financial statement the defendant attests to the truthfulness of the document and all attachments, we believe that unsigned copies of the defendant's tax return are sufficient. We believe that asking the defendant to sign a tax return which was already filed adds nothing to the waiver analysis.

***Recommendation 6:***

We agree with the recommendation that we must obtain credit reports, bank statements and income tax returns or clearly state to the Commission that those items are missing and explain why it is still appropriate to grant a waiver. We believe that our current process of requiring the staff to follow the procedures in the checklist prior to calendaring a waiver recommendation is an appropriate internal control. We will consider the recommendation that tax returns be signed after the fact.

***Finding 7:***

In this finding the Report cites to a single failure to produce a public database search.

***Recommendation 7:***

We concur in this recommendation. We believe that the procedures in the checklist are an adequate internal control as was exhibited in all but one of the items reviewed.

***Finding 8:***

The Report notes that we did not do any formal training specifically directed at waivers and we agree that training is appropriate. In fact, we recently included a mandatory session on waivers in our fall training program. During that training we explained the Commission's overall policy on waivers, we reviewed special considerations in making these recommendations and we went through the checklist item by item.

***Recommendation 8:***

We agree with this recommendation and have started implementing it.

## Office of Inspector General Response to Management Comments

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We are pleased that the Division of Enforcement (Enforcement) concurred with all 8 recommendations but are disappointed and concerned about Enforcement's overall response that they do not need to undertake any meaningful action to improve the disgorgement waiver process, stating for the most part that their existing controls and procedures are sufficient. Our concern is amplified by the fact that this is the Office of Inspector General's (OIG) third audit of this process and there does not appear to have been a great deal of recognizable improvement since the last audit conducted in January 2005.

Our audit found that there were \$177,605,521.03 in total waivers granted based on inability to pay among other policy reasons, for the period of FY 2006 through May 31, 2008. The audit report found many instances where Enforcement did not follow its own procedures and failed to ensure that defendants provided accurate assessments of their financial condition or submitted supporting documentation for assets, liabilities, income and expenses reported on defendants' Sworn Financial Statements. In addition, the audit found that Enforcement staff failed to obtain credit reports, bank statements, or income tax returns which are necessary to corroborate a defendant's financial status. In light of the large amount of disgorgements being waived and the significant findings of this audit report, we strongly urge Enforcement to attempt to improve its process by fully implementing all of the OIG's recommendations.

As we do with all of our audit reports, we provided Enforcement with significant time to respond to draft versions of the report and incorporated many of Enforcement's comments and perspectives into later versions of the report. In this instance, we provided Enforcement with an initial draft on September 8, 2008, and spent the next several months working closely with them to ensure that the report was entirely accurate. Notwithstanding this effort, the language and tone of Enforcement's response leaves us unconvinced that Enforcement will take the OIG's findings seriously and implement tangible and concrete measures to improve its disgorgement waiver process.

With respect to the particular cases cited by Enforcement in its response, the OIG's audit report explained its reasoning for all of these cases in narrative

form in the body of the report, and notes that in nearly all of these examples, although Enforcement now attempts to provide *ex post facto* explanations of waiver decisions (which were only provided after reviewing draft versions of the audit report), the waiver files do not support these explanations. Specifically, in several of these cases, Enforcement seems to have relied upon representations made by the defendant, rather than by obtaining supporting documentation. For example in case nos. 2, 12, 13, 15, 20, 27, 35 and 40, Enforcement acknowledged in its response that it based certain of its determinations either upon representations made by defendant or its counsel in interviews or depositions, and/or upon defendants' sworn statements, rather than relying upon supporting documentation as is required, and which is critical to ensure that these representations made by defendants who Enforcement believed violated the securities laws were truthful and accurate.

In addition, it is worth noting that the majority of the cases cited by the OIG in its audit are not disputed in Enforcement's response or even addressed at all.

We sincerely hope that Enforcement will carefully consider and implement all the findings and recommendations in this report in order to ensure that waiver requests are being appropriately granted.

## Criteria

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**17 CFR Section 201.630:** “ Inability to pay disgorgement, interest or penalties”.

**“Recommending Financial Waivers and Payment Plans to the Commission” revised as of January 14, 2005**

# Audit Request and Ideas

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The Office of Inspector General welcomes your input. If you would like to request an audit in the future or have an audit idea, please contact us at:

U.S. Securities and Exchange Commission  
Office of Inspector General  
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