

ENFORCEMENT DISGORGEMENT WAIVERS

EXECUTIVE SUMMARY

This audit followed up on audit No. 311 (issued January 11, 2001), which made several recommendations to improve the controls and guidance for disgorgement waivers. In response to the prior audit, the Division of Enforcement (Enforcement) issued guidance and took other steps to improve the waiver process.

We found that further improvements in the controls and guidance for reviewing disgorgement waivers are needed. In several instances, Enforcement staff did not obtain certain information to corroborate a defendant's financial statement assertions (e.g., credit reports, tax returns, Lexis/Nexis or Internet searches), as required by Enforcement's written guidance. Additionally, Enforcement's guidance did not clearly state whether certain steps were required or optional and did provide guidance on how to handle instances where defendants did not provide tax returns.

We are recommending that the controls and guidance for the waiver process be further enhanced. Also, the Action Memorandum to the Commission recommending the waiver request should describe the scope of the work performed to validate the information supplied and support the request for a waiver. Enforcement should also train its staff to obtain reasonable assurance that a defendant's financial statement assertions are accurate and to search for hidden assets.

Enforcement concurred with, and is in the process of implementing the report's recommendations.

OBJECTIVES AND SCOPE

Our objectives were to evaluate the adequacy of Enforcement's written procedures for the waiver process, and determine the extent of compliance with those procedures. The audit was a follow-up to our previous audit on disgorgement waivers.

We selected a sample of thirteen waivers granted in 2003 and 2004 to defendants in ten cases brought by Enforcement headquarters and field office staff. The thirteen waivers granted approximated \$16.8 million. During our review, we interviewed Commission staff, reviewed Enforcement's written procedures, selected and reviewed investigation files, and reviewed other relevant documentation.

The audit was performed from June 2004 to December 2004 in accordance with generally accepted government auditing standards.

BACKGROUND

Disgorgements represent repayment of ill-gotten gains (or losses avoided) resulting from individuals or entities violating the federal securities laws. The Commission seeks disgorgements to ensure that securities law violators do not profit from their illegal activity. Penalties represent fines levied on violators of federal securities laws. Disgorgements and penalties can be ordered in either administrative proceedings or civil actions, and the cases can be settled or litigated.

Payment of a disgorgement can be either completely or partially waived based on a defendant's sworn representations of financial condition. If a waiver is granted, the Commission does not assess a penalty.

In settled administrative proceedings, Enforcement staff (*i.e.*, headquarters and the field offices) may recommend that disgorgement be waived. The Commission makes the final decision. In civil actions, any settlement agreed to by the Commission must be approved by the district court.

In reviewing a waiver request, Enforcement procedures indicate that staff should request sworn financial statements, tax returns, and other information necessary to evaluate defendants' ability to pay. Additionally, the staff are to run a credit check on the defendants and perform Internet or Lexis/Nexis research on defendants, as well as their relatives and friends in certain instances, to corroborate the defendant's stated financial condition and identify hidden assets.

Enforcement staff are to obtain other information as appropriate to corroborate defendants' financial assertions (such as bank account, credit card and brokerage account statements, insurance policies, mortgage documentation, and similar information).

Our prior audit of disgorgements waivers found that improvements could be made to the waiver process to help ensure that the Commission had the necessary information to make a well-informed decision to grant a waiver. The Division of Enforcement concurred with our recommendations. It issued written procedures on waivers and hired firms to review previously granted waiver requests and make suggestions to improve the process.

Enforcement's guidance describes under what circumstances the staff should recommend that disgorgements be fully or partially waived, when a plan for delayed payment should be recommended, and how to present the issues involved to the Commission. The guidance is intended to promote greater consistency in making recommendations to the Commission to grant waivers.

In fiscal year 2003, the Commission ordered payment of \$900 million in disgorgements and waived approximately \$138 million.

AUDIT RESULTS

We found that, in several instances, Enforcement staff did not obtain certain information to corroborate a defendant's financial statement assertions (*e.g.*, credit reports, tax returns, Lexis/Nexis or Internet searches), as required by Enforcement's written guidance. We also found that the guidance, although reasonably comprehensive, did not state whether certain tasks were required or discretionary. The guidance also did not explain what to do when defendants did not provide tax returns.

Enforcement concurred with, and is in the process of implementing the report's recommendations.

WAIVER PROCESSING

In ten of the thirteen waivers reviewed, not all required documentation and adequate research was performed in accordance with Enforcement's guidance. The missing steps included (some waivers had multiple steps missing):

- For two waivers, credit reports were not obtained. (Waived amounts totaled \$143,000.);¹
- For four waivers, Enforcement staff did not obtain any tax returns
 - In three instances, the attorneys believed, or the defendants claimed they did not file tax returns; the attorneys did not verify this. (Waived amounts totaled \$296,440);
 - In one instance, the defendant gave Enforcement permission to obtain the tax returns from H&R Block, but the staff did not do so. (Waived amount totaled \$1,978);
- For three waivers, only some of the relevant tax returns were obtained. (Waived amounts totaled \$4,018,000);² and
- For three waivers, a Lexis/Nexis or Internet search was not performed. (Waived amounts totaled \$1,486,250) In an additional two waivers, the Lexis/Nexis search was not comprehensive enough. (Waived amounts totaled \$233,170)³

We also discussed with Enforcement officials several other steps that could be performed or considered when reviewing waiver requests.

Recommendation A

The Division of Enforcement should implement controls to ensure that

¹ In one of these matters all of the money was ultimately repaid to the harmed investor. \$37,000 in losses was avoided, which was also the amount lost by the investor.

² In one of these matters the misconduct started in December of the first year for which Enforcement obtained tax returns. The return for the prior year was missing. Enforcement obtained four out of five required returns.

³ Enforcement guidance was unclear as to whether this search was required. Enforcement plans to clarify this point in its guidance.

all required steps to support a waiver request have been performed, documented in the file, and reviewed by a supervisor. The guidance should also provide instructions on how to handle instances where defendants do not provide tax returns. These controls should be included in the written guidance governing waivers.

Recommendation B

To ensure that the Commission has the information to make a well-informed decision about granting a waiver, the Division of Enforcement should require its staff to describe the scope of their work on waiver requests in the related Action Memorandum to the Commission.

WAIVER GUIDANCE

Enforcement's current waiver guidance was issued on April 11, 2002. A related checklist was issued on May 23, 2002. In some respects, the guidance is not consistent, as described below.

- The May 23 checklist requires Enforcement staff to obtain loan and note documentation, Nexis/Lexis printouts or equivalent documentation. The April 11 guidance does not require these items.
- The April 11 guidance (exhibit 1) differs on what defendant tax returns are required. One part states that the returns are to be obtained starting a year before the alleged violations (Enforcement's actual position), while another indicates the staff are to obtain the returns from the date of the violation.
- The April 11 guidance includes bankruptcy schedules in a list of documents that must be obtained when appropriate (Enforcement's actual policy) and also in a list of documents that may be useful. The dual listing could cause confusion over whether the schedules are required or discretionary.

In addition, some Enforcement staff indicated their understanding that the waiver guidance presents best practices and discretionary guidelines only, and is not mandatory. This issue needs to be clarified.

Recommendation C

The Division of Enforcement should modify its existing waiver guidance to ensure that the guidance is consistent and accurately reflects Enforcement's intent. The guidance should indicate which tasks are required and which are discretionary (*i.e.*, best practices). Enforcement should also consider making its checklist a mandatory item to be completed and placed in the waiver file.

STAFF TRAINING

Our prior audit recommended that Enforcement determine the best organizational structure for effectively reviewing waiver requests (e.g., hiring a contractor to review waiver requests, establishing a separate Enforcement unit or a unit outside Enforcement with specialized expertise for this purpose). Enforcement decided that the attorneys working on a case would continue to perform the related waiver review because of their familiarity with the case.

Enforcement attorneys may need training in processing waiver requests and searching for hidden assets, as they do not perform this function routinely and may not have expertise in this area.

Recommendation D

Enforcement should train its staff to obtain reasonable assurance that a defendant's financial statement assertions are accurate and to search for hidden assets.