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

December 17, 2019

TO: Stephanie Avakian, Co-Director, Division of Enforcement
Steven Peikin, Co-Director, Division of Enforcement
William Hinman, Director, Division of Corporation Finance
Robert B. Stebbins, General Counsel

FROM: 
Carl W. Hoecker, Inspector General

SUBJECT: *Final Management Letter: Evaluation of the U.S. Securities and Exchange Commission's Delinquent Filings Program*

In June 2019, the U.S. Securities and Exchange Commission's (SEC, agency, or Commission) Office of Inspector General (OIG) announced an evaluation of the SEC's Delinquent Filings Program (DFP). The objective of our evaluation was to assess the SEC's process for identifying, tracking, and notifying delinquent filers and issuing related revocation orders and/or trading suspensions in accordance with applicable laws, rules, and regulations. We also reviewed the Division of Enforcement's (ENF) efforts to reallocate resources to the DFP. This management letter summarizes the results of our evaluation. This letter contains non-public information about the agency's processes and management decisions regarding the DFP. We redacted the non-public information to create this public version.

Executive Summary

The DFP's mission is to encourage reporting companies delinquent in filing periodic reports to become and stay current with the reporting requirements of the Securities Exchange Act of 1934 (the Exchange Act or Act),¹ and to take action against those who do not. According to ENF officials, since 2004, the DFP has generated approximately 5,000 revocation orders and 2,200 trading suspensions related to delinquent filers. Moreover, ENF's DFP employees worked through a backlog of about 2,000 delinquent filers and produce about 7 to 15 percent of all Commission actions each year.

To determine whether the DFP's processes and internal controls were operating effectively, we conducted interviews; reviewed applicable laws, rules, regulations, and policies and procedures; and examined supporting documents for a sample of delinquent filers. We also surveyed ENF employees newly assigned to the DFP.² Generally, we found that the DFP had

¹ As amended through P.L. 115-141, enacted March 23, 2018 (codified at 15 U.S.C. § 78a et seq.).

² We further discuss the work performed, including our sampling and survey methodologies, on page 4 of this management letter.

adequate processes for identifying, tracking, and notifying delinquent filers and recommending related revocation orders and/or trading suspensions in accordance with applicable laws, rules, and regulations. Based on our testing, we also concluded that the DFP adhered to its policies and procedures and maintained adequate documents to support its recommendations to the Commission. Finally, those employees who responded to our survey generally believed that they have received sufficient training and written guidance to fulfill their new DFP responsibilities. As a result, it appears that the DFP is well-positioned to continue pursuing its mission.

Nonetheless, two issues came to our attention that warrant management action. First, among other potential changes, the Division of Corporation Finance (CF) is assessing its ability to take a more active role in identifying companies that become delinquent or are likely to be delinquent, which could precede, overlap, and possibly impact the work conducted by ENF and CF's Office of Enforcement Liaison (OEL). Second, delegating certain authority related to the Exchange Act could improve the efficiency of the DFP. These issues and our recommendations to address them are discussed further below.

Background

The Exchange Act requires companies with registered securities to file periodic reports with the SEC.³ Periodic reports—which include annual and quarterly filings (Forms 10-K and 10-Q, respectively)—disclose information about the companies' financial condition and business practices to help investors make informed investment decisions. According to the SEC, most companies submit their periodic reports in a timely manner. However, some companies (referred to as "delinquent filers") fail to submit periodic reports, file materially deficient periodic reports, or do not submit the reports in a timely manner. The Exchange Act Section 12(j) (12(j)) allows the SEC to revoke an issuer's securities registration if the SEC finds that the issuer violated the Act by failing to file its periodic reports. In addition, the Exchange Act Section 12(k) (12(k)) allows the SEC to suspend trading in a security for up to 10 business days if the SEC believes that a suspension is required to protect investors and the public interest.⁴

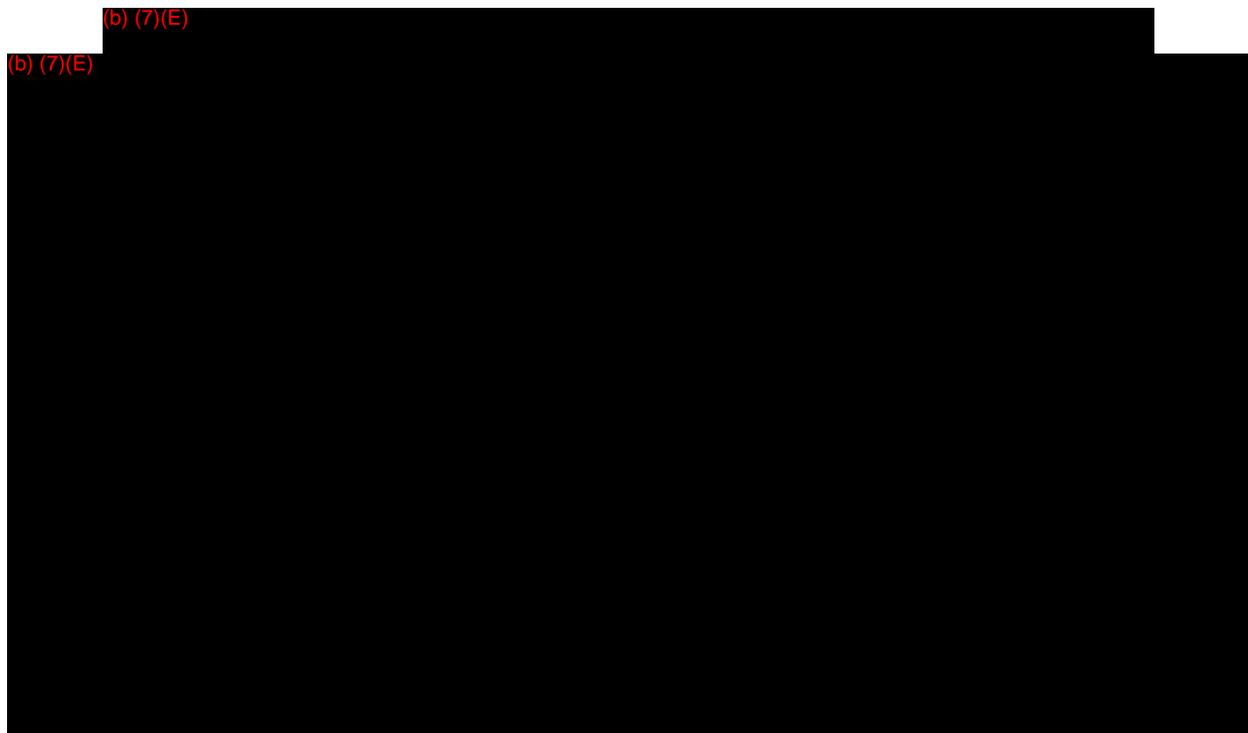
The DFP is jointly executed by CF and ENF. CF seeks to ensure that investors have access to material information in order to make informed investment decisions, both when a company

³ Section 12(g) of the Exchange Act establishes thresholds at which an issuer is required to register a class of securities with the SEC. An issuer is required to register a class of equity securities under the Exchange Act if: (a) it has more than \$10 million of total assets at the end of a fiscal year, and (b) the securities are "held of record" by either 2,000 persons, or 500 persons who are not accredited investors. An entity can also voluntarily register a class of securities under Section 12(g). Even if a company does not have a class of securities registered under Section 12(g), it still may have to file reports with the SEC if the company lists its securities on an exchange (which would require the class of securities to be registered under Section 12(b)) or has an obligation to file reports created by Section 15(d). Those reports are available to the public through the SEC's Electronic Data Gathering, Analysis, and Retrieval system.

⁴ A trading suspension by the SEC prevents a security from trading on all trading platforms (such as national securities exchanges, over-the-counter markets, or alternative trading systems).

initially offers its securities to the public and on an ongoing basis. ENF conducts investigations into possible violations of the Federal securities laws for failing to make required filings with the Commission, as well as corporate insiders who fail to file the appropriate forms with the Commission regarding their personal securities trades, and prosecutes civil actions and administrative proceedings in this area. In 2004, CF and ENF jointly established the DFP to recommend administrative proceedings under 12(j) to revoke the registrations of securities of issuers that are significantly delinquent in their periodic reports and have been unresponsive to SEC requests for compliance.⁵ Pursuant to 12(k), ENF seeks Commission approval to suspend trading of the securities of the non-filing issuers under certain circumstances. Such 12(j) revocations and 12(k) trading suspensions help to prevent continued purchases and sales of securities in the U.S. market for which accurate information does not exist, thereby protecting U.S. investors.

The figure below shows employees from ENF and CF's OEL work together to (1) identify reporting companies that are delinquent filers; (2) notify the companies of their failure to submit required periodic reports, urge compliance, and warn of possible ENF action without further notice; and, when necessary, (3) recommend the Commission approve actions to revoke the company's registration and, as appropriate, suspend trading.



⁵ An enhanced DFP for issuers was needed because publicly traded companies that are delinquent in the filing of their Exchange Act reports deprive investors of accurate financial information upon which to make informed investment decisions. Furthermore, these entities are often vehicles for fraudulent stock manipulation schemes. In the past, the Commission brought civil injunctive proceedings against issuers seriously delinquent in their periodic filings, but injunctions—which, in essence, require an issuer to do that which it is already obligated to do—failed to cure the problem.

Between 2004 and 2018, two ENF investigative attorneys were assigned full-time to the DFP and were assisted by certain litigators. One of the two investigative attorneys retired in December 2018. The remaining investigative attorney plans to retire at the beginning of 2020. Recognizing the impending loss of institutional knowledge, beginning in early 2019, ENF management reallocated resources and assigned 16 additional employees to the DFP.⁶

Objective, Scope, and Methodology

The objective of our evaluation was to assess the SEC's process for identifying, tracking, and notifying delinquent filers and issuing related revocation orders and/or trading suspensions in accordance with applicable laws, rules, and regulations. We also reviewed ENF's efforts to reallocate resources to the DFP.

We conducted our work at the SEC's Headquarters between June and December 2019. We interviewed ENF and CF personnel to identify each division's role in the DFP, as well as individuals from the Office of the Secretary (OS) and the Office of the General Counsel (OGC). We also surveyed the 16 ENF employees newly assigned to the DFP to assess the appropriateness and sufficiency of the training, policies and procedures, and guidance provided to the employees.⁷ We reviewed applicable laws, rules, and regulations and relevant policies and procedures; ENF's and CF's fiscal year 2018 management assurance statements; and databases used to track and monitor delinquent filers. Finally, we obtained data from ENF's case management system for the period between October 1, 2017, and June 30, 2019, to select and review a judgmental sample of 10 delinquent filings matters and supporting documents.⁸

We conducted this evaluation in accordance with the Council of the Inspectors General on Integrity and Efficiency's *Quality Standards for Inspection and Evaluation*. Those standards require that we plan and perform the evaluation to obtain sufficient, competent, and relevant evidence to provide a reasonable basis for our findings, conclusions, and recommendations based on our evaluation objective. We believe that the evidence obtained provides a reasonable basis for our findings, conclusions, and recommendations based on our evaluation objective.

⁶ The 16 employees included 4 assistant directors and 7 staff attorneys from the SEC's Headquarters in Washington, DC; 1 assistant director, 1 staff attorney, and 1 management and program analyst from the SEC's New York regional office; and 2 assistant directors from the Microcap Fraud Task Force.

⁷ Our web-based survey was open between August 12 and August 23, 2019, and was not mandatory. The survey included both closed- and open-ended questions—with opportunities for employees to provide additional information to open-ended questions—and did not require respondents to answer all questions.

⁸ During our scope period (that is, between October 1, 2017, and June 30, 2019), the SEC filed 364 matters for delinquent filings generated by the DFP and suspended trading of the securities of 398 issuers. However, not all of these trading suspensions were attributable to the DFP, because the SEC may also suspend securities for issuers stemming from other sources, such as tips, complaints, and referrals.

Results

The DFP Had Adequate Processes and Adhered to Its Policies and Procedures.

Generally, we found that the DFP had adequate processes and adhered to its policies and procedures for identifying, tracking, and notifying delinquent filers and recommending related revocation orders and/or trading suspensions in accordance with applicable laws, rules, and regulations. Both ENF and OEL established detailed procedures outlining the steps to take before recommending 12(j) and 12(k) actions to the Commission. Specifically, ENF guidance provides a process for determining whether a security is registered under Section 12(g) of the Exchange Act and, therefore, is eligible for revocation; steps for preparing the action memorandum and other required documents; and sample documents and templates. ENF also maintains a process for determining whether securities of a delinquent filer are ripe for a trading suspension, and a guide on how to prevent inappropriate trading suspension recommendations in delinquent filings matters.

CF's DFP procedures provide the steps OEL should take once a delinquent filer has been identified to determine whether a delinquency letter should be sent. In addition, OEL's guide provides post-delinquency-letter procedures and communications and guidelines for reviewing action memoranda.

ENF also built an application, which pulls information from various internal and external systems to assist in identifying delinquent filers. Moreover, ENF and OEL both maintain databases for tracking pertinent information related to delinquent filers and delinquency letters, respectively.

We conducted more than 20 interviews with ENF and CF personnel and reviewed a sample of delinquent filings matters and supporting documents to determine whether the DFP's processes and related internal controls were operating effectively. For each company included in our sample, we sought to determine whether ENF and OEL:

1. adhered to criteria for issuing delinquency letters;
2. maintained required documents supporting all communications with the company;
3. established and maintained support for 12(j) and 12(k) recommendations to the Commission;
4. obtained proper approval on 12(j) and 12(k) actions; and
5. made publicly available 12(j) and 12(k) orders and final revocations.

Generally, we found that ENF and CF followed policies and procedures and maintained adequate documentation.

The DFP Is Well-Positioned To Continue Pursuing Its Mission. Although the DFP has been mostly staffed by a small number of employees since its creation in 2004, the program is well-positioned to continue to meet its mission despite the above referenced ENF retirements. As previously mentioned, beginning in early 2019, after one of the two investigative attorneys

retired, ENF management assigned 16 additional employees to the DFP and tasked the remaining investigative attorney (expected to retire at the beginning of 2020) with training those newly assigned. In August 2019, we surveyed the 16 ENF employees newly assigned to the DFP to assess, among other things, whether the employees received sufficient training and written policies and procedures for identifying and processing delinquent filers, and whether the employees had any concerns about their ability to fulfill their DFP responsibilities.

Generally, employees who responded to our survey believed they had received sufficient training and written guidance to carry out their new duties.⁹ For example, 7 of 8 respondents to one question said the training they received was adequate to prepare them to identify, research, and recommend delinquent filers for delinquency letters and subsequent recommendations for revocation orders and trading suspensions. Additionally, 6 of 8 employees responded that the written policies, procedures, and guidance provided were adequate to assist them in their jobs, and 7 of 8 employees did not have any concerns about their ability to perform their DFP responsibilities.

Although our findings were largely positive, two issues came to our attention that warrant management action. First, among other potential changes, CF is assessing its ability to take a more active role in identifying companies that are delinquent, which could precede, overlap, and possibly impact the work conducted by ENF and OEL. Second, delegating certain authority for 12(j) actions could improve the efficiency of the DFP. We describe these issues in further detail below.

Organizational and Operational Changes Within CF May Impact the DFP. CF is planning organizational and operational changes that may impact the DFP. (b) (5)

(b) (5)

CF has not yet formalized any changes to its role related to these filers, but plans to present any proposed changes to ENF management in fiscal year 2020.

Because CF's organizational changes are still in the planning phase, ENF management was not fully aware of the extent of CF's proposed changes. Therefore, ENF's training of the employees newly assigned to the DFP has not accounted for these potential changes to the program.

We recommend that CF formalize its plan for any changes that may impact the DFP, and as appropriate, coordinate with ENF: (a) any changes that may impact the DFP, and (b) updates to training, policies, and procedures that are reflective of the program as it evolves.

Delegating Certain Authority for 12(j) Actions Could Improve Efficiency. The Commission has the authority to delegate specific functions of its own authority to any SEC

⁹ Half of the 16 employees we surveyed completed the survey in its entirety, while the remaining half either partially completed the survey or did not respond at all. We also surveyed eight contractors involved in the DFP. Only two contractors provided partial responses, and none completed the survey. As a result, we did not consider the results obtained from the contractors.

division or office, giving that division or office decision-making authority on the functions and issues so delegated. Although the Commission may not delegate some functions, such as rulemaking, the Commission has previously delegated authority for resolving 12(j) actions in specific circumstances. Delegating authority in more circumstances could improve the efficiency of the DFP.

Under the current process, ENF requests authorization and institution of 12(j) actions via seriatim consideration.¹⁰ Specifically, ENF requests that the Commission authorize and institute public administrative proceedings against the named subjects pursuant to 12(j) to determine whether the Commission should revoke the registrations of the subjects' securities based on the failure to file timely periodic reports. According to ENF policies and procedures, ENF circulates action memoranda to the Commission for seriatim consideration because the issues rarely contain controversial recommendations. For efficiency, ENF usually combines (or batches) unrelated issuers into single proceedings and circulates among the Commissioners relevant materials and supporting documents for each matter.

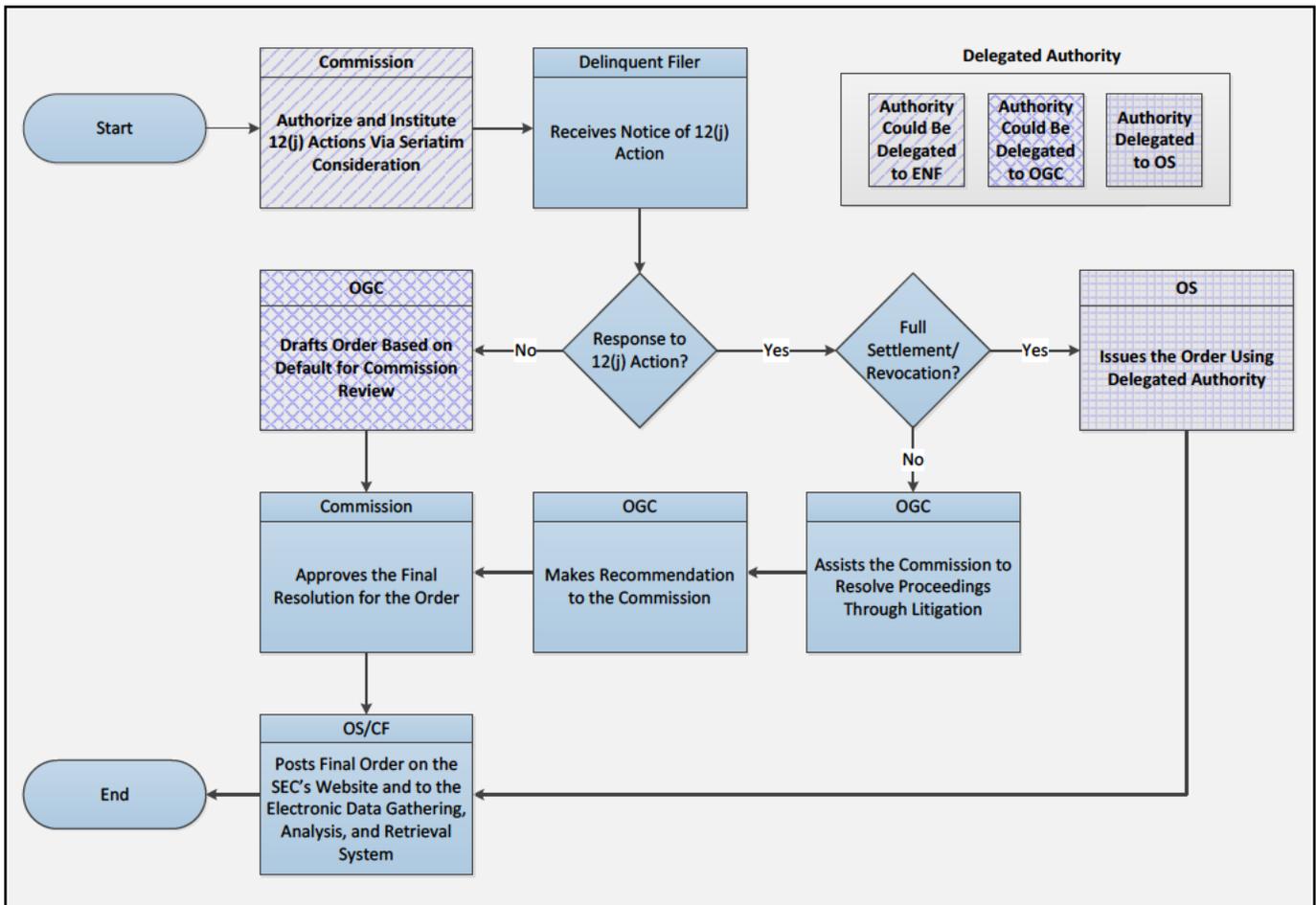
Once the Commission authorizes and institutes public administrative proceedings, the proceeding has to be resolved through settlement or litigation. Proceedings that are settled with full relief can be issued by OS through delegated authority. Until June 2018 the Commission instituted 12(j) proceedings by setting them for a hearing before the SEC's administrative law judges (ALJs), and the ALJs had authority to make an initial decision.¹¹ After the ALJs made their initial decision, OGC had delegated authority to issue finality notices in cases where no party appealed and the Commission did not call the matter for review on its own initiative. The Commission had to approve all other initial decisions made by ALJs.

After June 2018, the Commission began instituting 12(j) proceedings by setting them for a hearing before the Commission itself. As a result, the ALJs are not involved, and OGC is now responsible for assisting the Commission in resolving the proceedings through litigation. However, OGC does not have the delegated authority to issue a decision; therefore, OGC can only make a recommendation to the Commission, which approves (through seriatim consideration) the final resolution of proceedings settled through default and litigation. Figure 2 depicts a summary of the process as of November 2019 and highlights steps where the Commission could delegate its authority to ENF and OGC.

¹⁰ Pursuant to 17 CFR 200.42(a), *Disposition of business by seriatim Commission consideration*, when joint deliberation by the members of the Commission upon any matter is unnecessary, impracticable, or contrary to the requirements of agency business, but the matter should be the subject of a vote of the Commission, the matter may be disposed of by circulation of any relevant materials among all Commission members. Each participating Commission member reports his or her vote to the Secretary. The matter is not considered final until each Commission member has reported his or her vote or has reported his or her intent not to participate in the matter.

¹¹ In June 2018, the Supreme Court held in *Lucia v. SEC* that the appointment of the SEC's ALJs violated the U.S. Constitution's Appointments Clause, requiring a new hearing in front of a different fact finder and causing the Commission to stay all pending administrative proceedings. *Lucia v. SEC*, 138 S. Ct. 2044 (2018).

Figure 2. Key Steps for Resolving Proceedings as of November 2019



Source: OIG-generated based on interviews of ENF, OS, and OGC personnel.

According to officials in ENF, OS, and OGC, additional delegated authority for aspects of 12(j) actions could save time and resources. For example, the Commission would not have to spend time reviewing and approving the resolution of cases if OGC had delegated authority to issue final orders in cases where the party was in default. At times since the inception of the DFP, OGC and ENF have each considered whether to seek delegated authority for the DFP. We recommend OGC and ENF consider whether to pursue or not pursue delegated authority related to the DFP.

Conclusion

Generally, the DFP has adequate policies and procedures in place for identifying, tracking, and notifying delinquent filers and recommending related revocation orders and/or trading suspensions. Moreover, the DFP adhered to its internal policies and procedures and maintained adequate documents to support its recommendations to the Commission. Although the DFP is facing an impending loss of institutional knowledge, ENF management has reallocated resources to the DFP and provided training and written guidance to employees new to the DFP. Therefore, it appears the DFP is well-positioned to continue with its mission

going forward. However, we are making two recommendations to CF, ENF, and OGC management as follows:

1. We recommend that CF formalize its plan for any changes that may impact the DFP, and as appropriate, coordinate with ENF: (a) any changes that may impact the DFP, and (b) updates to training, policies, and procedures that are reflective of the program as it evolves.
2. We recommend that OGC and ENF consider whether to pursue or not pursue delegated authority related to the DFP.

On November 8, 2019, we provided SEC management with a draft of our management letter for review and comment. In its November 22, 2019, response, management concurred with both recommendations, stating that, should there be changes within CF that impact the DFP, management will coordinate and make updates to policies, procedures, and training resources as needed. Additionally, OGC and ENF will each consider whether to pursue delegated authority related to the DFP. Management's complete response is reprinted as an attachment to this final management letter.

Management's proposed actions are responsive; therefore, the recommendations are resolved and will be closed upon completion and verification of actions taken. We request that, within the next 45 days, management provide the OIG with a written corrective action plan that addresses the recommendations. The corrective action plan should include information such as the responsible official/point of contact, timeframe for completing required actions, and milestones identifying how management will address the recommendations.

We appreciate the courtesies and cooperation extended to us during the evaluation. If you have questions, please contact Rebecca L. Sharek, Deputy Inspector General for Audits, Evaluations, and Special Projects.

Attachment

cc: Jay Clayton, Chairman
Sean Memon, Chief of Staff, Office of Chairman Clayton
Bryan Wood, Deputy Chief of Staff, Office of Chairman Clayton
Peter Uhlmann, Managing Executive, Office of Chairman Clayton
Kimberly Hamm, Chief Counsel/Senior Policy Advisor, Office of Chairman Clayton
Robert J. Jackson Jr., Commissioner
Prashant Yerramalli, Counsel, Office of Commissioner Jackson
Hester M. Peirce, Commissioner
Jonathan Carr, Counsel, Office of Commissioner Peirce
Elad L. Roisman, Commissioner
Matthew Estabrook, Counsel, Office of Commissioner Roisman
Allison Herren Lee, Commissioner
Andrew Feller, Counsel, Office of Commissioner Lee
Gabriel Benincasa, Chief Risk Officer
Rick A. Fleming, Investor Advocate
John J. Nester, Director, Office of Public Affairs

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Holli Heiles Pandol, Director, Office of Legislative and Intergovernmental Affairs
Benjamin Schiffrin, Associate General Counsel, Office of the Associate General
Counsel for Adjudication

Margaret McGuire, Senior Counsel to the Co-Directors, Division of Enforcement

Anita Bandy, Associate Director, Division of Enforcement

Timothy Henseler, Chief, Division of Corporation Finance

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
100 F Street, NE Washington, DC 20549

MEMORANDUM

To: Rebecca L. Sharek, Deputy Inspector General for Audits, Evaluations, and Special Projects, Office of Inspector General

From: Stephanie Avakian, Co-Director, Division of Enforcement
Steven Peikin, Co-Director, Division of Enforcement
William Hinman, Director, Division of Corporation Finance
Robert B. Stebbins, General Counsel

Date: November 22, 2019

Re: Management's Response to the Office of Inspector General's November 8, 2019 Draft Management Letter, *Evaluation of the U.S. Securities and Exchange Commission's Delinquent Filings Program*

Thank you for the opportunity to review and provide comments on the Office of Inspector General's draft management letter: *Evaluation of the U.S. Securities and Exchange Commission's Delinquent Filings Program* ("Draft Management Letter"). We are pleased that your review determined that the program is operating appropriately and is well-positioned to continue pursuing its mission. We appreciate the courtesy your staff has extended to us and we welcome the benefit of your observations.

The SEC's Delinquent Filings Program plays an important role in the agency's mission of investor protection. Through the program, the Divisions of Corporation Finance and Enforcement work together to recommend actions against publicly traded companies that are significantly delinquent in the filing of their Exchange Act reports. Such delinquency deprives investors of important and timely information, and may indicate companies that are susceptible to becoming vehicles of fraudulent stock manipulation or other schemes that harm investors. The Delinquent Filings Program has resulted in approximately 5,000 revocation orders, and 2,200 trading suspensions related to delinquent filers since 2004. These results were achieved through our uniquely tailored and effective processes for identifying, tracking, and notifying delinquent filers; and recommending, filing, and litigating related revocations and trading suspensions as appropriate.

As your letter observes, the program is well-positioned to continue to operate in an efficient and effective way, due in large part to the processes developed by, and the resources dedicated to the program. To the extent there could be changes in the future that may impact the operation of or authority under the program, we concur with the two recommendations in the Draft Management Letter. Should there be changes within the Division of Corporation Finance that impact the program, we will coordinate, and make updates to policies, procedures, and training resources as

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needed. Similarly, the Division of Enforcement and the Office of the General Counsel, which assists the Commission in adjudicating litigated proceedings involving delinquent filers, will each consider whether to pursue delegated authority related to the program.

Thank you again for the opportunity to respond to the Draft Management Letter. We remain committed to maintaining the Delinquent Filings Program to promote timely Exchange Act reporting, and as an effective program to thwart fraudulent schemes that may harm investors.

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